Insurance - Managing Director at Corsair Capital

Interview conducted on January 31, 2024

Topics
M&A, Private Equity, Brokerage, Acquisition, Integration, Financing, Technology

Summary
The Tegus Client had conversations with the Managing Director at Corsair Capital covering various topics. They discussed the playbook for consolidators in the retail broker market, including the minimum EBITDA figure for funding acquisitions. They also talked about deal flow, integration strategies, and the importance of commercial lines in the financial data industry. The Managing Director emphasized the need for operational and commercial integration and the potential for growth in smaller businesses. They also discussed identifying the right management team, the importance of technology, and the risks in M&A activity. Lastly, they clarified the concept of contingent commissions and highlighted the value of owning the underlying book of business for an agency.

Expert Details
Managing Director at Corsair Capital. The expert can speak to being on the board of Oakbridge, and spending a lot of time evaluating, investing, and managing insurance broker aggregators and can speak in depth to investment with Oakbridge.

Managing Director at Corsair Capital. Corsair Capital is a private equity investor focused on financial services and healthcare services. The firm has invested in Miracle Mile: a $4bn AUM wealth management platform, Oakbridge: a Retail P&C insurance brokerage platform focused on the southeast, Spring Venture Group: a Digital senior health insurance distribution platform, and First Eagle: a $120 billion-plus asset manager focused on multi-asset and private credit strategies.

They have extensive experience in rolling up senior health insurance brokerages, DTC digital distribution platforms as well as traditional FMOs.

Q: Can you speak to the M&A dynamics at insurance agency consolidators?
A: Yes, led Oakbridge transaction and was on board. Invested in 25 plus tuck ins.

Q: Can you speak to the post-acquisition integration process and how this various across the industry?
A: Yes, direct experience with Oakbridge. Took 4 businesses and combined into 1.

Q: On a scale of 1-5 with 5 being the highest how familiar are you with Oakbridge Insurance, Inszone, Acrisure, PCF Insurance?
A: 5 for Oakbridge, 2 for Inszone, 3 for Acrisure, and 4 for PCF.

Tegus Client
Hello. I appreciate you taking the time to speak. I've been asked to look into the kind of retail broker market and would love to kind of dive into your experience with Oakbridge. And specifically, just trying to get a -- I think, like fundamentally get an understanding of what one would define as the PE playbook in the space for a consolidator. It might be helpful if you just jump into like your experience and then I definitely want to like dive into the early stages of your time working on that platform. But I'll just defer to you for a second.

Managing Director at Corsair Capital

Yes, sure. So my experience, I was at my prior firm for about 12 years, and I left last summer on good terms. And as part of my time there, I was spending quite a bit of time looking at insurance services and insurance distribution, including the retail brokerage space, that we had identified that market as an interesting one, probably four, five years ago. It's an area where there's been a lot of private equity money and success and I think the playbook hasn't really changed too much where you try to find a platform that is of scale.

And I think generally, people are targeting things that are around $10 million of EBITDA because at that level, you could actually afford a proper management team and resources to really integrate the business and also trying to find businesses that had some historical experience around M&A, so that's their DNA.

They have some background there and then you can accelerate that with the right hires, either head of business development or other resources, including the right debt facility and the delayed draw. The space obviously is pretty attractive. If you want me to go into any of that topic to?

Tegus Client

Can I ask you just a question about would you -- in order to get in front of lenders and start funding acquisitions with debt, what's like the minimum EBITDA figure.

Managing Director at Corsair Capital

I would say even at $5 million, you can probably get a level of interest because I think this industry is pretty special compared to other verticals in financial services where there are some lenders that will only look at insurance brokerage because no one's really lost money on the lending side.

There're probably some corner cases there. And some of the investment communities just love the space. They're very aggressive on the terms. So I think at $5 million, you can start finding some interest. I do think a lot of them want there to be a sponsor behind it, where it was just a management team and some kind of family investors, non-institutionalized, they get a little bit nervous.

But when there's a sponsor involved, then they get pretty generous on both the terms of the upfront facility. But then in particular, like the delayed draw is very critical for these businesses. So their ability to -- maybe they'll do a deal where they'll borrow $50 billion upfront as part of a recapitalization, but then they want to have another $30 million to $50 million of delayed draw that they used to fund the acquisitions.

And that's, I think, pretty important these days just because the market is relatively mature. Targets are being bombarded with inquiries from bankers and aggregators and having the capital available to execute is pretty critical for them, and they're pretty aware of what it looks like and what the right valuation is. It's kind of no longer a secret.

Tegus Client

Got it. And in terms of structuring the acquisition of a target, I mean I see -- I guess -- and this is new to me, whether it's like buying the agency itself, buying books of business and then have earn-outs and.

Managing Director at Corsair Capital

Yes. Different people have different models there. I think there're some models like PCF where they buy a lot of small agencies that are really just one or two people shops and they can buy that at a pretty discounted level, probably in the mid-single digits of EBITDA. And then you have businesses like Oakbridge or Sunstar, where they're buying firms that actually have some infrastructure.

And I think $1 million revenue is kind of a threshold, I think, where it starts becoming a little bit more institutionalized and you start thinking about it a bit differently. And those have really increased in valuations where five years ago, you could buy them at 8x. Now they're usually anywhere from like nine to 11, which you'd be surprised for such a small business. Now you can also structure them using earn-outs, so it's pretty common for people to have an upfront of nine or 10.

And then depending on if they hit revenue targets over the next two years, get another turn off of that. But earn-outs very are very common in this industry to get people to the right overall package that they're looking for. I'd say you see them in probably 80% of the deals for the ones that are slightly larger, for the small books of business, those probably have less earn-outs.

Tegus Client

And so a question on like agency that's around $1 million in commission revenue. Again, I'm sorry, I'm new to space, so my terminology is.

Managing Director at Corsair Capital

No, no, no.

Tegus Client

Agency commissions is like $1 million. And I'm seeing that -- they're basically breakeven, but it's probably like a management's lifestyle business, like what are the pre and post margins the way that you would look at like diligencing, yes.

Managing Director at Corsair Capital

Yes. I mean I think usually the smaller places, they don't have much infrastructure. So the margins can be pretty high. It's really sometimes just the compensation that, that producer is making, which is more about like a payout grid structure.

So before you buy it, the margins can be probably in the 40% to 50% level. Now once you bring them on, there's not much incremental costs associated with that given the operating leverage of the broader platform. But most of the platforms that I've seen, the good ones, they end up in that kind of 35% margin range.

Tegus Client

And when you say margin, are saying like agency revenue minus producer commissions?

Managing Director at Corsair Capital

Yes. So basically, EBITDA margins is usually what I think about. 35% is usually the right place for a platform that's invested. Because I think a lot of times you see information in books where people are showing like a 40% or 50% margin.

Tegus Client

You [got this all like] zero, sorry. And I'm just like looking at businesses where -- I'm just trying to understand if I look at the P&L of a small agency.

Managing Director at Corsair Capital

Yes, I see what you're saying. Sometimes they are taking out all of the excess revenue as income.

Tegus Client

So that's what I was trying to say like, I see them, but I just want to get a sense of like what should it look like. What.

Managing Director at Corsair Capital

Yes, typically, like if they are part of a larger platform, usually the compensation structure will be altered where they get a payout of their book as opposed to being able to take out everything because they're the sole producer. So like think about the payoffs as being around 40% to 50%. And then there's overhead and other corporate expenses that bring you down to that margin of 35% EBITDA for the whole franchise.

Tegus Client

That's really helpful. And then that kind of gets to a question here, like, you had mentioned that as a sponsor you're looking for experienced management team, the team that's done M&A before and has some sort of playbook behind that. I would be curious to -- like, if you could just give me an overview of like what that playbook looks like? And also specifically like the sourcing side, how they're finding new deals for the pipeline. But.

Managing Director at Corsair Capital

Sure. So just to start on the playbook perspective, when looking at brokers, I think there were a few criteria that we look for. And we had looked at a ton over the years, and there were some that were growing, but buying kind of any type of business at really cheap multiples, even though they're shrinking.

So if I had to summarize like things that were important for us, I think organic growth is a metric that you want to look at very closely. And it's a little bit tricky because some of the growth is coming from rates increasing over the past few years. In the environment you've seen some CAT events that caused rates to harden, you see some carriers pulling out of markets, which allowed also the premiums to go up. So rule of thumb was that in the past few years, people were getting anywhere from like 3% to 5% of organic growth just from rates.

Tegus Client

Yes, so the reason [Technical Difficulty] (00:09:48) drivers of organic growth are new loss that still makes sense to me and then rate and exposure. And I had to assume those rates and exposure, but yes, sorry, to interrupt you.

Managing Director at Corsair Capital

So that's kind of free growth if you can maintain your book. The other components of organic growth is obviously retaining your existing book. So usually, you see renewals of good businesses in the low 90s, I would say. And if you can get that, your book is replenishing pretty consistently, and that's why investors like the industry because everyone comes back for you on a pretty regular basis.

And then the last component of organic growth is the new business that they go out to get. And I think -- like when I looked at everything as a whole, I think you're always trying to find brokers that were in the high single digits of organic growth. And I think they've grown double digits, that's fantastic. I think some of these businesses, because they're focused on personal lines or smaller books, they've had mid-teens, but that's probably hard to sustain as you get bigger in size.

But high single digits is good. And even mid-single digits is fine as long as they can grow inorganically. So that's kind the first thing, making sure that they have a pretty consistent, strong base to build on. And there were some brokers we looked at that had zero growth, negative growth, but some people still invested in them because they were growing inorganically, like 30%, 40%.

Then going on to that M&A thing, I think it is helpful for a broker to have some experience or history of M&A. And usually, they'll be doing smaller deals before a sponsor comes in because they don't have the [fire powder] and what we try to look for there is what has been their approach and ability to source deals? Where is that coming from?

And I think what you'll see is that bankers surprisingly, are less common sources of deals for brokers in that $10 million to $30 million EBITDA range. Once you get $50 million of EBITDA plus then usually, things will be banked because there'll be larger deals. But a lot of the time.

Tegus Client

Even $10 million to $30 million, they're generally not banked. That's interesting.

Managing Director at Corsair Capital

Yes. So what I'll say is that the banks were not a big source of deal flow for some of the brokers that I've worked on, which has been surprising. You would have thought that, oh, half of your deals will be coming from bankers, I think it's probably closer to like 10% at the end of the day. And that's because they're very expensive, and they send it out to everybody.

What ends up happening is that usually you have to leverage the agencies' relationships and network, which means like whenever you do these aggregators, it's probably like anywhere from five to 10 principles that were founders of those agencies that came together. And then usually, they know the next like three or four agencies in their region or their city or their community, and they're able to bring them on when they say, "Hey, look at the exciting equity story we have here, we can really triple your money in three years," things like that.

And some of these agencies are also part of the state associations like -- every state tends to have these groupings of brokers where they get together, they're not equity holders in each other, but they're affiliated and then they try to go to carriers and get better contingent commissions and other benefits of being -- kind of having their volume aggregated.

So just understanding like have they been able to tap into that network, do they have clear visibility on, hey, these are like the three other agencies in my city or my state and we've had dialog for a year, et cetera, that gives you a bit more credibility when you think about pipeline development and having those targets. So that's kind of one thing we look at for the M&A.

And then the last thing I'll say just because I think it's important, and I want to make sure I get the playbook clearly out to you is their philosophy around integration. And I think integration is a term that gets thrown around very loosely. When people don't really aren't specific about what exactly they mean by that, they just say it because it sounds good. There's a lot of basic integration that are table stakes.

That would be around having everyone on the same payroll, having everyone on the same IT system, getting the same e-mails. That level of integration is basic. And if you don't have that, then your business is just going to fall apart. So everyone usually has that. And some people, by having that say that they're integrated. When I think about integration, I think about it more operationally and commercially integrated, which means that there's one fixed or set producer grid.

So a lot of the times when businesses buy other agencies, they let people stay on whatever payout and grid they had before. Okay, you are getting 50% of your commissions and that's fine, you were gaining 30%, whatever. The better businesses will realize, hey, that's not really scalable or sustainable and you're going to constantly have to renegotiate, and you face a lot of complexity on the talent side. Let's have one universal grid that rewards production, both from your existing book and then new business and have that be standardized.

And then some people will read about it. And maybe they leave. But at the end of the day, that's much better for the business and much easier for management to run. So that's an example of like good integration, that's above and beyond the basics.

Another example would be around claims, where usually unintegrated businesses, when there's a claim that comes in, it goes to the local office, it goes to the local admin or client service representative and then they kind of handle it themselves kind of on a local basis.

The better businesses will have more centralized claims where everything goes to one team, usually at the biggest office or headquarters, and then they're going to manage it more effectively alongside the carriers and have more of a process around it that's consistent. So that's another example of integration.

Tegus Client

Yes. I was going to actually get to that about how the -- from a valuation standpoint because just with cursory research online, it appears that the market isn't giving credit for just like smashing things together with whether like they're not growing or like obviously a premium for organic growth, but like they're not going to give you credit for like integrations matter. The level of integration, just speak to like the investors are becoming more certain about that.

Managing Director at Corsair Capital

It matters because I think when it's done poorly, then an asset becomes much harder to trade. If you get the basics, I think that attracts a lot of people. If you get things that are super good, you do get some uplift of multiples, like one thing historically that I have thought about was what's the trade-off between integration and inorganic growth because there's been some players like World Insurance or PCF, that have taken the approach of, "Hey, let's just buy more targets and grow faster.

Tegus Client
Got it.

Managing Director at Corsair Capital
Yes. But what's interesting is that I don't think the market has penalized that as much as you would have thought, where like if you're truly like great integration, you might get like a turn or 1.5 turns more for your platform.

Tegus Client
Right. It's a huge operational profit.

Managing Director at Corsair Capital
Yes. But if someone is growing at 100% versus 50%, you don't get compensated enough for that additional 1.5 turns for the integration work you do.

Tegus Client
That makes sense. And then this is another area that I need some education on is basically like the product mix, whether it's like policies and carriers and there was something I read that you've got to be overweight commercial. But I'd just love to get your perspective on like how you -- yes.

Managing Director at Corsair Capital
Yes. It's interesting because in the end of the day, there's really three business lines that matter. Its commercial lines, which is working with small businesses and medium-sized businesses. The second would be personal lines. That would be your home and auto and things that you're commonly familiar with.

And the last one is employee benefits. They're helping them manage their health carriers and what the right kind of policies would be putting their employees in. I think the rule of thumb has historically been that commercial is a more attractive space. It's a tougher space because your clients are more likely to be targeted by other brokers. So there's a bigger risk of losing clients. But when you think about -- sorry?

Tegus Client
Because it's like the structural retention is going to be higher just for.

Managing Director at Corsair Capital
It's interesting where it's not necessarily -- sometimes you would think commercial -- you would have thought commercial be higher, but like personal lines can be pretty plug-and-play, where -- if someone is on an auto policy, I think it's on auto pay. I think it's not really going away unless.

Tegus Client
Yes, yes, sometimes. Yes.

Managing Director at Corsair Capital
Yes. So when you look at it, sometimes commercial lines is higher, sometimes personal lines is higher, so it's not a great rule of thumb. I think why commercial lines is more value is that it's harder to build out. There's more ability to scale it, where once you have a good team around a certain industry or a certain product, you can go out and market that and be able to get more organic growth that's chunkier, that you can eventually try to cross-sell other products more effectively.

Because with personal lines, you really just have home, auto as the main one, and there's really hard to find other ancillaries. With commercial, you obviously have your general insurance, you have property, you have cyber. So there's a lot more ability to cross-sell. And I think there's more expertise required. So I think generally, people prefer commercial.

I think like the good mix that I've always found was around 60% commercial, maybe 20% to 30% personal lines and then 10% to 20% employee benefits. I think that's a nice balance where you want to see that. You don't want to see a business that's all one or the other because those markets do have different dynamics. So it's an increased way of getting diversification if you have a balance between that business mix.

Tegus Client

And is it slightly -- I was kind of dipping all over the place. One question I just have a multiple -- I also read that the bigger is better, kind of adage doesn't really apply any more like you're not -- there's not a -- yes.

Managing Director at Corsair Capital

Sorry, when you say bigger is better.

Tegus Client

The same business at scale will have better multiples or higher EBITDA multiples from a valuation perspective than it would, like -- that's not necessarily -- more -- that's what I wanted to -- yes.

Managing Director at Corsair Capital

I think that's fair because the industry has historically in recent years traded anywhere from, I'd say, like 15x to 17x for scaled players. I think for some smaller underinvested businesses, you're probably in the 13% to 15% range. And your point, I think, is a fair one because you've seen some smaller businesses get up to that 17x level and some bigger ones get down to that 15% kind of floor.

And part of it is just because the ability to grow is very different, where it's much easier for a $30 million EBITDA business to double than a $200 million EBITDA business. There's just not enough scale targets for them to get that growth rate. So I think even though the bigger ones are more stable, better institutionalization, better management teams, I think they still get similar multiples because the growth is different than the smaller ones. So that adage, I think, is fair.

Tegus Client

I'm still kind of wrapping my head around how large this market is because it's -- but like the fact that you sell, you exit enough of a runway to continue the plan . Like.

Managing Director at Corsair Capital

I mean I think you could argue that like if the company is that $30 million to $40 million of EBITDA, that's still considered pretty small. Where you've $1 billion EBITDA kind of public companies, you have these like private equity aggregators that have like $200 million to $500 million EBITDA. And there's still quite a bit of runway for something in kind of that level to get north of 50. And I think having the right team, the fact that it's built out like I think that was pretty attractive to some of those players in the space.

Tegus Client

That's correct. So because from where I'm sitting, my team would be involved very, very early on. And like it's interesting to see in the Oakbridge story, like I think it was four or seven agencies or whatever, yes, maybe agencies in the Atlanta area 2020, you guys came in not that far after that.

And I'm curious like, how do you think about identifying like the right management team for that? There's like soft skills associated with it because we would want to get in -- like we would want to find the team to like get behind the guy who puts the four agency standards.

Managing Director at Corsair Capital

Yes. I think when you look at the market, there's usually a lot of teams floating around that say they can do it, but they don't have a platform and then you might have some smaller businesses that want to be an aggregator that don't have a team. So it's rare to have that combination come together.

I think when you assess the teams, it's just given that this market is not new anymore. I think you have to start from looking at people who've done it before at different institutions in their career. And maybe they were the #2 or the #3 person and maybe this is their third go around where they've done it twice with others.

But to me, that has not a lot more credibility in being the core part of that new team. And they have the right, I think, relationships with the bankers. They have the right relationships with a certain community to get the ball rolling. So you have to have someone who's done it before, another aggregator at this point.

Tegus Client
Can you find people like that under $5 million EBITDA scale like for some reasons.

Managing Director at Corsair Capital
Yes. I think you can -- good sources of that would be talking to some of the specialist banks that focus on the space. So MarshBerry,. because I think they're always talking to people who want to do something similar to an Oakbridge or Sunstar or something. So one of the ways that they've done it is that they try to match people together where they know a good team that's looking for the right sponsor or they know a smaller platform that needs the right backing.

And sometimes they do that for some of these platforms to help them get the ball rolling. So that's one source as you talk to those bankers. I think you can always try to look at people who were ahead of M&A for brokers because at the end of the day, I think that's actually the most important skill set is someone who is credible around M&A, who have the network of potential targets and knows how to execute on that.

On the managing an insurance broker perspective, I think that skill set is easier to have and develop. And it has less -- that's a skill set that keeps the lights running versus actually giving the sponsor the type of returns that people want to see in this market.

It's so important for them to get momentum in the first or second year because it's very easy for there to be a very delayed S-curve and it takes two or three years to get momentum, at that point, your cost of capital versus your return, it just doesn't look as attractive if it takes time. So someone who has kind of an existing track record there, I think is pretty critical.

Tegus Client
And is geography, it seems like it's kind of like a regional -- a lot of these are like regional businesses. Is that.

Managing Director at Corsair Capital
I would say a lot of the aggregator platforms tend to be more national because it's just easier if you can hunt in a lot of different places. I think being a regional platform is better because you have more specialization. You're able to customize your offering to the industries of that region. So in the Southeast, you have agriculture, like manufacturing, things like that.

But it limits your M&A targets. So it's a trade-off. I think most people end up doing something where it's maybe like two or three regions because I think being truly national, it's tough but you might have someone that says, "Oh, we're going to do the Northeast and then the Midwest or we're going to do the Southeast or Texas," things like that.

And I just think like it's probably easier to have more flexibility on geography just because it allows you to hit your growth targets in the beginning easier. So I would probably think having some flexibility there is okay.

Tegus Client
I guess, is there anything you think I'm missing or like anything that you would add that I didn't ask that is important to be thinking about in terms of like -- or like examples of other.

Managing Director at Corsair Capital

So I mean I'll say there's a lot of -- so there's the industry things which we've spent quite a bit of time on. But then there's a lot more like tactical aspects of the sponsor universe here and the process where this is an industry that's been invested in for the past decade very successfully. And it kind of feels like we're probably in like a 6th or 7th inning out of nine, when it comes to where the trends and the themes are.

So this is an area that you're interested in. I think it's just -- it's very important that you spend a lot of time with your committee getting them comfortable ahead of any process that this is an exciting one because when these businesses go to market, they end up trading very quickly, usually a player pre-empts the process, so two weeks before the final bid, they'll kind of do fully marked-up documents.

And usually, they've had a lot of connectivity with the teams that are existing, and they know them, and they have a lot of conviction around it. Another thing that ends up happening is that a lot of sponsors end up losing two or three processes. And then when the third or forth one comes around, they're like, okay, fun's over, no more BS, we're going to just win this one. So that's kind of the landscape that you're going to be playing in for these brokers.

I do think the opportunity -- so there's really like two pathways that I see for sponsors right now. One is trying to get a relatively scaled business, kind of, let's say, anywhere from $20 million to $40 million of EBITDA and be willing to pay up a good premium for it because you're getting something that has pretty low downside variance. Your upside is going to be not as high as it used to be.

Because -- I think sometimes people, when they run their model, they're surprised by how much leakage or dilution happens along the way. So even if a business like triple or quadruples the EBITDA, when you think about the equity return, it can get diluted pretty meaningfully by the fact that you've had to raise a lot of debt to finance it. So you've also had to usually give out equity to targets when you buy them. So that's dilutive.

You have to have a management incentive plan that can be anywhere from 10% to 15%. And then usually, you have to invest in the business in the early years, put in indexer $1million or $2 million of corporate overhead in order to find the CEO, CFO or build out their personal lines' leader or things like that. So I think being mindful.

Tegus Client

When you said -- sorry, [Technical Difficulty] (00:31:27) before you said the management plan, you said this like for employees mean like because you have to give up -- you have to incentivize them to -- or for like ask them to roll over a lot of their equity. Is that exactly what you mean?

Managing Director at Corsair Capital

So yes, there's two ways of equitizing them like you can ask them to roll over. And I think different firms have different philosophies on that. Some people like to have a pretty equal shareholding between them and the founders and operators and others that want to buy as much equity as possible. So there's that rollover piece.

But then usually, you're going to have to give -- you're going to have to create a management incentive plan for your CEO, CFO, other people, that can be 10% to 15% of the upside. And when you do deals, you're not always using cash considerations by targets. Sometimes you might be giving them 75% cash consideration, 25% equity.

Tegus Client

That's what I'm thinking.

Managing Director at Corsair Capital

Yes. So you get diluted by -- going forward, they get the benefit from that upside that you no longer get to have. But at the end of the day, I think it's better to have alignment and it's the position there versus people just getting a paycheck and then going out the door. So making sure you have the right equity structure is pretty important to manage that.

I'm trying to think what else is relevant. I think the debt is super important. That's really what makes this run where finding a firm -- like when you look at packages, it's pretty important that there's a pretty meaningful delayed draw because some firms might do a lot more upfront at great terms, but they have much less capacity for future deals. I would trade more delayed draw at higher rate like all days of the week because that's what funds your growth.

And most likely, if you're having success, you're going to have to go back to them in another like 1.5 years, two years to get another delayed draw to fund that. But just having that flexibility is just very important in order -- because these deals happen pretty quickly, they target to uncertainty.

So if you don't have that, that's definitely a disadvantage in the process when you're going against some of the larger aggregators. Some other firms have considered doing lines of equity as well. So not only do you have a debt delayed draw, the firm has pre-committed to put in additional $30 million to $100 million of equity, so they find something more transformational or larger than they're able to execute on that with the backing of the sponsor.

But when you say pre-committed, the sponsor usually still has a final say on whether that money get support or not, but it just has more visibility to the management team and to the target to know that, that exists. And there's probably some pre-wired valuation mechanism to make sure that there's no negotiation every time it's being drawn.

Tegus Client
Got it. And I think in your terminology, correct me if I'm wrong with the way that -- what I would say is like this is like a follow-on equity reserve that you have, like we're putting X in today, but we're reserving Y for a potential future.

Managing Director at Corsair Capital
Yes. I would say that is probably more tangible than just the reserve because many funds can reserve capital more informally where like they say, "Hey, we're going to put $30 million of soft for this one, which means that you can't touch it and then we'll look at other deals." But if they actually call on it, then you have to negotiate it, you have to like go through a lot of legal docs, et cetera.

What I'm saying is that it's sometimes better to negotiate upfront what a line of equity looks like, which means that if this deal comes along, we're going to pre-negotiate at what valuation the equity comes into the company at. We're going to negotiate when you can call on it, like what are the mechanisms?

And then that way, if there's three or four deals that they want to do that are larger that needs equity, you're not having a negotiation every single time. And usually, you can set that up in a way that's pretty favorable to the sponsor because the company is basically getting liquidity that's pre-negotiated so they should be willing to take a lower valuation of that equity coming in or other kind of bells and whistles there. So that's just one mechanism that I've seen that's been successful for some players.

Tegus Client
I've got one last question. It's pretty big, but I just saw this in the report as well. This has been extremely helpful for informing me on this strategy, but how important is technology to the business model? Because in this course, buyers can be skeptical about a tech-enabled story, like how.

Managing Director at Corsair Capital
Yes. I think tech prevents things from going wrong, but it rarely helps things go much better.

Tegus Client
Right. You're not -- who's the.

Managing Director at Corsair Capital

Yes. Like if you had to kick the tires on the tech, I think the thing that people focus most on is the agency management system which is just kind of like software that allows people to put in all their policies, manage their claims and centralize all the database, all the information into one place.

I think what you've seen, though, is that there's like two or three players to offer that. And sometimes, you have these aggregators, which have multiple agency management systems that don't speak to each other. And so that makes it very difficult for the CFO or the CEO or the controller to really extract data that's usable.

Tegus Client

Is that -- when you say line integrations, you're saying like everybody is going to be on the same.

Managing Director at Corsair Capital

Yes. So that's -- yes, I think getting everyone on the same agency management system will ultimately result in better data, which will result in better management and performance. So I think that's something that is not universal. Someone that's able to say that, hey, we're all on the same platform that puts them in the top quartile, I'd say of like, okay, these guys -- or maybe like top third or something.

But that's probably the thing that people care most about on technology. I think other types of technology that you're seeing is firms are outsourcing some of their claims work to these tech-enabled providers that are able to -- those players tend to offshore a little bit to like Philippines or India or whatever, but then they have software that kind of like reviews everything and cleans it up and all that stuff.

That's probably the other area where you see quite a bit of technology is around claims and people that are using vendors, I think that shows a level of sophistication of the team where they recognize it doesn't make sense to hire like someone to try to do that in-house, someone outside of the house will do it much better. So that's probably the other area of technology. There's a whole like area of insurtech where there's kind of these smaller tech-enabled brokers like.

Tegus Client

That makes it value driver for say like, we want to acquire a insurtech and like there's.

Managing Director at Corsair Capital

I just think that they've gotten such little market share and such a little traction.

Tegus Client

Yes, AMS space is so concentrated. It's pretty crazy.

Managing Director at Corsair Capital

Yes. So I just think that like these direct-to-consumer tech-enabled brokers, like that's something that's been around for a decade, and they probably still have less than like 1% market share after all that. And I think that's because they -- go ahead, sorry.

Tegus Client

No, no, no.

Managing Director at Corsair Capital

I was just going to say that, like I think part of it is just that there is a pretty -- there is a lot of complexity in insurance where there's new products coming out. There's new risk emerging and having access to carriers is pretty important. And a lot of these like newer players, these insurtechs, they might not have all of the coverages that someone is seeking or they might have a carrier panel that's much more limited.

So the product is often inferior to a more established broker. We were never that concerned that these insurtechs would take over too much share. We have to do the diligence. But like every single -- at the end of the day, you want somebody to like strangle or call if you have an insurance issue versus a robot.

Tegus Client

Yes. No, definitely. And sorry, I just maybe think of one other thing. Just noticing that like the M&A activity in 2023 was down a lot. But when digging into the numbers, it was really led -- it was really caused by two businesses, PCF, which you had mentioned and Acrisure and PCF, like I don't know the details behind it, but it says -- just a headline was PCF presses pause on acquisition spree and cuts staff after hitting debt ceiling.

And then Acrisure, they just -- it seems like they're just talking about integrating, getting everything under one brand name like and that was the reason like the two, like what can go wrong like debt issues and then integration issues, but I'd love to hear you speak to those two and just like what can go wrong question, yes.

Managing Director at Corsair Capital

So when I think about what can go wrong, like the debt one is a very clear one. Where I think with like PCF, basically, they were pretty leveraged. And partly, that was the lender's fault because they kept giving them more and more at better and better terms.

Tegus Client

But the management buyout first and then that's when they hit.

Managing Director at Corsair Capital

Yes. Yes. So like I think some of these players get up to like 7x or 8x, which is pretty high. And then they end up also buying quality that's poor. I mean the issue with PCF is that they grew like crazy and they bought everything, and they didn't care the quality of that revenue, how well integrated it was. Some of these targets, they shrink after you buy them because the producer has bought out, it's a lifestyle business. He's not going out and getting new business.

So people who are buying revenue at any cost, like it works until it doesn't. And then at some point, the growth slows and they get penalized for it. But the debt is something that you have to be mindful of. And part of it is having your own discipline where like the lenders will probably give you something.

There's so much lenders out there, the cost of capital in this industry is so low that they'll be fine giving you like 7x, but you might want to say, hey, let's run it at 6x and let's put equity in alongside of it so that there's always a cushion for them to be opportunistic when something big comes along.

So one thing that you've to be mindful of is obviously managing the debt and the cash flow. And I think that with all these businesses, like understanding what cash flow is versus EBITDA, it's pretty important. So really doing the bridge because sometimes these businesses don't have any real cash flow. Everything in EBITDA gets adjusted. So just be mindful of that.

Then the other risk is sometimes, you buy bad businesses, and the business is a trade. So it's very easy to buy a lot of things and all studies say, "Hey, this business is now down 20%. If you have two or three of them, that really does create a headache." So there's examples I think of businesses like Relation, for example, that's a broker in the space, which didn't buy the highest quality businesses, some parts of their business were slowing.

And even though they were pretty scaled, they had trouble finding a transaction because, hey, do we really want to buy a business that has zero organic growth or maybe slightly negative even if it has a lot of inorganic growth? I think a lot of sponsors have said that you can't just buy through M&A, way out of a poorly managed business that's not integrated.

The lack of integration point, I think you could get away with it for a while, but I think it does create a lot of operational complexity that requires additional cost and takes time for you to get information. People have been able to dictate their way to pretty big businesses without them falling apart.

But I think the issue is that, okay, now you have a data breach or all of a sudden, there's like you realized -- I think the main thing about lack of integration that gets people is the number -- the data integrity. I think a lot of these business today end up -- because they didn't integrate, they thought their platform is doing fine. And then all of a sudden, they're like, "Oh, actually, like this business was down 20%." That's where I've seen the lack of integration really play out is you get surprises around what you thought you had. So that's the risk there.

I think other risks to think about contingent commissions. We really didn't talk about that. That's actually a pretty meaningful part of this business and this industry where sometimes carriers are willing to offer up additional commissions depending on how their loss ratios and underwriting performance is.

And for some of these brokers, they have a very large exposure to contingent commissions, because maybe they wanted more upside or they really believe that they're delivering great business. So that's one thing to diligences understanding what percentage of their total commissions and revenue is contingent? And then.

Tegus Client
Help me with understanding of contingent commissions because I.

Managing Director at Corsair Capital
Sorry, I missed what you said, what you said?

Tegus Client
Just like the high-level view of contingent commissions, like I'm not even that familiar with the concept.

Managing Director at Corsair Capital
Oh, it's good. Contingent commission is basically saying, okay, we're going to pay you like 30% of premium for your business, and that's ordinary commissions. But they might say, hey, if you bring us really good underwriting, which means that -- so like part of -- to understand contingent commissions, you have to understand how insurance companies make money.

And basically, the way they make money is that they get premiums for this insurance coverage, but they have losses when they have to pay claims. And ultimately, you have something called combined ratio, which is how much is your losses and expenses versus your revenue? And if you have a combined ratio that's 70% or 80%, that means for every dollar of revenue that I'm receiving, I'm paying out $0.80 on losses and expenses, but I'm getting to keep $0.20 on profit.

So these carriers basically go to these brokers and say, hey, if you provide me really good quality business, so their clients aren't really risky and they're doing all the stuff that's going to cause claims. And my underwriting -- my combined ratio is 70%, I'll give you X dollars more. If my combined ratio is like 80%, then I'm going to give you less. So it's a sliding scale versus the guaranteed commission. Like a profit share is a way of thinking about it.

And some of the businesses in this industry, they have a very large exposure to that just because either the products that they're writing is a more contingent commission-oriented product or because they want to have more skin in the game or more upside potential.

So they're going to be like, "Okay, I believe in my own cooking, so I'm going to take more contingent upside potential versus guaranteed." But that can bite you where if all of a sudden, like auto accidents go through the roof, you might have contingent commissions that are down like 50% or zero.

Tegus Client
So if I'm understanding that correctly, if you were out there, you're going to buy an agency that relies heavily on contingent commissions, like that's a big portion of their revenue and then you buy them and then that [bite] some because they don't hit those numbers. Is that.

Managing Director at Corsair Capital
Yes, that means your revenue or EBITDA could go down pretty meaningfully. Because the contingents tend to be pretty high margin. Because it's not like you're doing much more work to get them. That's the other thing because it's high margin, that means it has an outsized impact on EBITDA than a regular commission because you're paying out a producer and other things.

So it's always important to make sure you understand the contingents and to go into detail, like who are like the top three carriers on your contingents and what do those contracts actually look like. So when you're looking at those contracts and if it's something that's more ordinary course like auto coverage, like auto is a pretty macro thing, a lot of cars, though, it's going to be hard for that to fluctuate too much.

But if you're writing contingents on nursing facilities or like hospitals, one big issue can cause that contingent to evaporate. So I am just thinking, sure, you have a graph around that is helpful. And usually, there are other -- I said that's the negative, the risk side. But on the upside, usually as a new sponsor, you can renegotiate the contingents or try to get more contingents out of your carriers because you can promise them more premiums over time.

So one thing you see is when a sponsor buys it, one of the first things they try to optimize is the contingents, let's try to go back to the carriers, when we get bigger, we have more volume, we're delivering them. This should give us a better rate. So that's an area of upside too.

And just one last risk that's also important is making sure that the producers are locked in because some of -- it's rare for brokers to fail, but some of the times where we've seen them fail is because large teams leave and they bring their books to a competitor.

There's not too much you can do about it in some states because some states' non-competes are not really valid. So you really have to make sure that the compensation profile is in line with what they could be getting in other places. And the best way I found to lock people in is through some type of equity incentivization.

Tegus Client
That was incentivizing the rollover kind of in dilution.

Managing Director at Corsair Capital
But yes, the rollover is usually for like more of the existing equity holders.

Tegus Client
You're just saying.

Managing Director at Corsair Capital
Yes. They're usually important producers, but like a lot of these smaller places, the equity hasn't gone that far down the organization. So it's really identifying who are the most important producers that are not equity holders? And how do we give them management incentive plan units or other type of things so that if they leave, it just goes away. And that's really the main economic hammer you have versus any kind of contract.

Tegus Client
Because I saw that like if an agency has producers, but the producers own their own book versus agency-owning it, like you're going to want to buy them out with that? Or is it okay to keep them part like owners of their book? Like I'm not as clear about the mechanics behind it. I'm.

Managing Director at Corsair Capital
Yes. I think buying out the book basically means that, okay, we're going to buy your clients and your relationships, but we're going to have somebody else service them. So you're going to like retire or -- while buying the agency, they're still required to service their existing customers but also go out and find new business.

Tegus Client
And if you're an agency, you would want to own the underlying book. Like you wouldn't want.

Managing Director at Corsair Capital

Yes, for sure. Because like in the end of the day, like the value of an agency is around the client relationships to the end client. And the more you have control over that -- and that goes back to the point around integration where one of the benefits of integration, having one brand and one system is that your clients associate their relationship with the firm versus the producer.

Obviously, the producer is important, but like as you get bigger and bigger, the producer becomes less important, which creates more franchise value for the firm. So it's important always to understand that because there's a lot of other models. And one thing you have to be careful about when you look at these businesses is that there are some businesses called like insurance marketing organizations, where all they're doing is they're providing a middle and back office to insurance agents.

And they're getting some kind of payout for that either an override or a share of revenue, but they have almost zero ownership of that client. They're just basically allowing the agent to use their back office, use their carrier relationships. But if that agent wants to move their business to somebody else, they could do that tomorrow and there's like really no recourse.

So just make sure that you have a true retail -- and that's why some people like the retail aspect of these brokerage platforms because you need to have a storefront people know -- people are going to go to that like physical location to get business versus calling somebody on the phone. So that creates more permanency and more stability.

Tegus Client

Got it. All right. Well, this has been unbelievably helpful. So I really appreciate it. Have a good one.
