Article Title: ARCHIVE | Criteria | Insurance | Specialty: U.S. Insurance Broker Criteria Data: (EDITOR'S NOTE: — This article has been superseded by "Key Credit Factors: Criteria For Rating Insurance Brokers," published May 29, 2013.) This article presents a comprehensive discussion of insurance broker analysis. Many of the criteria used to evaluate insurance brokers are similar to those used to evaluate other corporate entities. However, given insurance brokers' unique credit fundamentals and their operating environment, key differences are also identified. The financial leverage metrics demonstrated by the fastest-growing insurance brokerages are more aggressive than other types of companies in their rating categories. When an industry is run on personal relationships and grown by acquisition, the resulting balance-sheet quality is often poor. Specifically, goodwill and other intangible assets often constitute substantially all of a company's equity. Accordingly, many insurance brokers have negative tangible net worth. Liquid assets are not generally available to service debt. Instead, debt servicing is sourced from the sector's cash flow generation capabilities. Cash-flow analysis is the single most critical aspect of credit rating decisions for insurance brokers. It takes on added importance for speculative-grade issuers that constitute the majority of the insurance brokerage rated space. Although companies with investment-grade ratings generally have ready access to external financing to cover temporary cash shortfalls, speculative-grade issuers lack this degree of flexibility and have fewer alternatives to internally generated cash for servicing debt. Insurance brokerage provides cash generated service. Cash-flow ratios show the relationship of cash flow to debt and debt service, and also to the company's needs. The ratios themselves are affected by stand-alone financial strength as well as outside forces, most particularly property/casualty (P/C) cyclicality factors, regulatory risks, and mergers and acquisitions. Because insurance brokers' commission streams are variable and their costs are relatively fixed, the point in time in the P/C rate cycle plays a prominent role in determining the sector's level of organic cash flow capabilities, profitability, and growth potential. Generally, during a hard market, P/C premium rates are increasing, and in a soft market such as today, commercial lines P/C premium rates are decreasing. In late 2007 and early 2008, we believe prices have declined by 3%-4% for many small and regional accounts and 8%-10% for large national accounts. Because insurance brokers' commissions are normally proportional to premiums, organic revenues shrink during soft market conditions, albeit not to the same degree as insurers. During soft market conditions, insurance brokers up sell products to try to make up lost revenue. Though some of the anticipated ups and downs of the P/C rate cycles are factored into the credit rating all along, ratings are not a mere snapshot of the present situation. Accordingly, one can expect to see more volatility in the speculative-grade category. This reflects the interest uncertainty and potential heightened financial risk that such a company may exhibit in contrast to its investment-grade counterparts. One may expect a speculative-grade rating to vary over time during the cycle. Although, Standard & Poor's Ratings Services' credit ratings are meant to be forward-looking, the time horizon for a speculative-grade issuer is shorter than for a higher rated company that may be more insulated from cyclical influences. Accordingly, one can expect to see more frequent ratings and outlook changes for speculative companies. Insurance brokers are subject to regulatory scrutiny. Regulatory changes affect the sector's competitive landscape, business models, and client relationships. A regulatory charge against a firm may impair its reputation among customers. Conversely, competitors often capitalize on market disruption by hiring established producers from questionable firms, though it takes a few years to realize an increase in revenue productivity. Accordingly, an insurance broker's cash-flow ratios may fluctuate following times of regulatory uncertainty. These aspects were amply demonstrated during regulatory investigations that took place in the middle of this decade. The insurance brokerage industry is fragmented and opportunities for growth through consolidation are plentiful. Often insurance brokers choose to use free cash flow to fund acquisitions over prepayment of debt. Conventional wisdom for this choice is that leverage (debt to last-12-months [LTM] EBITDA) will ultimately improve due to increased combined earnings. Standard & Poor's takes a conservative view when incorporating pro forma earnings into its analysis. Because integration and execution risks exist, we downsize the consolidated firm's earnings potential. In addition, pro forma financials are not always as reliable as smaller acquired targets' historical financials are often unaudited. Standard & Poor's incorporates an insurance broker's acquisition appetite into our credit analysis. Management's stated acquisition goals and past takeover bids, including those not consummated, provide a basis for judging prospects for future acquisitions. We focus on the financial flexibility measure, debt to LTM adjusted EBITDA as well as other cash flow analysis metrics recognizing that the strength of these companies comes from its cash flow generating capabilities. We use LTM adjusted EBITDA as an approximate run-rate for cash flow available to service debt. Debt to LTM adjusted EBITDA indicates how many years it will theoretically take an insurance broker to accumulate enough cash to repay debt. Because speculative-grade insurance brokers generally have a short time to maturity, between five to eight years, they are susceptible to refinancing risk especially because of their lower degree of access to capital market than its investment-grade counterparts. Insurance brokers have used the noncancelable operating leases and unfunded retiree obligations as sources of additional off-balance-sheet financing. We adjust all ratios, accordingly. The Standard & Poor's ratings universe for U.S. insurance brokers includes about 10 companies (see table 1). Table 1 Broker Rating History 2006 2005 2004 Marsh & McLennan Cos. BBB BBB BBB Aon Corp. BBB+ BBB+ BBB+ Willis Group Holdings Ltd. BBB BBB- BBB- USI Holdings Corp. BB- BB- BB- Alliant Holdings I Inc. NR NR B HMSC Corp. B+ B+ NR AmWINS Group Inc. B B NR Arrowhead General Insurance Agency Inc. B NR NR HRH BB BB BB Ratings And Ratios Means The key ratio means for U.S. insurance brokers by rating category and their definitions are displayed in table 2 and table 3. Means were chosen over medians due to the rated sector's small statistical group. The ratio means are purely statistical, and are not intended as a guide to achieving a given rating level. They are not hurdles or prerequisites that should be achieved to attain a specific debt rating. Caution should be exercised when using the ratio means for comparisons with specific company or industry data because of differences in method of ratio computation, importance of industry or business risk, and the impact of mergers and acquisitions. Because ratings incorporate more than quantitative historical financial analysis, ratios of a particular company at any point in time may not appear to be in line with its assigned debt ratings. Particular caution should be used when making cross-border comparisons because of differences in accounting principles, financial practices, and business environments. Strengths and weaknesses in different areas have to be balanced and qualitative factors evaluated. Standard & Poor's considers the point in time in the insurance P/C rate cycle when evaluating credit metrics. Presented are key financial ratios, long-term, during a hard P/C market. Credit metrics during a soft P/C rate cycle are weaker and are not available for illustrative purposes at this time. This article will be updated in 2009 when statistics for a soft market cycle are available for meaningful presentation. For this reason, we are not releasing 2007 financials at this time. The universe of rated companies constantly is changing, and in certain rating categories, adding or deleting a few companies also can affect the financial ratio means. There are many nonnumeric distinguishing characteristics that determine a company's creditworthiness. Note: Past mean scores for each rating category do not dictate future rating assignments. Table 2 Key Financial Ratios, Long-Term, During Property/Casualty Hard Market THREE-YEAR (2004 TO 2006) MEAN OPERATING STATISTICS BBB BB B Adjusted EBITDA fixed-charge coverage (x) 6.5 4.1 2.5 Adjusted EBIT fixed-charge coverage (x) 6.0 2.4 2.1 Debt + hybrid to LTM adjusted EBITDA (x) 1.8 3.1 4.4 Total obligations to LTM adjusted EBITDA (x) 3.3 3.8 4.9 Adjusted EBITDA margin (%) 19.3 16.6 25.1 Adjusted pretax return on revenue (%) 14.5 5.6 11.9 CASH FLOW STATISTICS Adjusted operating cash flow fixed-charge coverage (x) 5.4 4.1 2.2 Adjusted operating cash flow interest coverage (x) 5.4 4.1 2.6 Table 3 Key Ratio Definitions Adjusted EBITDA fixed-charge coverage (x) (Adjusted earnings from continuing operations before interest, tax, depreciation, and amortization + implicit lease interest expense + implicit retirement obligations interest + preferred dividends) divided by: (Interest expense + implicit lease interest expense + implicit retirement interest + preferred dividends) Adjusted EBIT fixed-charge coverage (x) (Adjusted earnings from continuing operations before interest, tax + implicit lease interest expense + implicit retirement obligations interest + preferred dividends) divided by: (Interest expense + implicit lease interest expense + implicit retirement interest + preferred dividends) Debt + hybrid to LTM adjusted EBITDA (x) (Long-term debt + current maturities + commercial paper + other short-term borrowings + Hybrid Debt) divided by: (Adjusted earnings from continuing operations before interest, tax, depreciation and amortization + implicit lease interest expense + implicit retirement obligations interest) Debt to LTM adjusted EBITDA (x) (Long-term debt + current maturities + commercial paper + other short-term borrowings) divided by: (Adjusted earnings from continuing operations before interest, tax, depreciation and amortization + implicit lease interest expense + implicit retirement obligations interest) EBITDA margin (%) (Adjusted earnings from continuing operations before interest, tax, + implicit lease interest expense + implicit retirement obligations interest) divided by: Revenue Adjusted pretax return on revenue (%) Adjusted earnings from continuing operations divided by: Revenue Adjusted operating cash flow fixed-charge coverage (x) (Operating Cash Flow + retirement redundancy/(deficiency) -earnouts + taxes paid for operation disposal – restricted or fiduciary cash changes in working capital + implicit lease interest expense + implicit retirement obligations interest + preferred dividends) divided by: (Interest expense + implicit lease interest expense + implicit retirement interest + preferred dividends) Appendix Company data are adjusted for the following Nonrecurring gains or losses are eliminated from earnings. This includes realized capital gains, gains/losses on asset sales, extraordinary legal and regulatory settlements, early extinguishment of debt, significant transitory income items, unusual losses, recapitalization/leveraged buyout costs, extraordinary restructuring charges, mandatory earnouts in relation to acquisition related revenues, unrecognized pension and postretirement service costs, and charges because of asset write-downs. These adjustments chiefly affect interest coverage, return, and operating margin ratios. Unusual cash-flow items similar in origin to the nonrecurring gains or losses also are reversed. Cash flow from operations This measure reflects cash flows from operating activities, not investment and financing activities. It includes interest received and paid, dividends received, and taxes paid in the period. Additionally, for some items such as postretirement benefit and asset retirement obligations and taxes paid, we include the (net) cost for the period rather than actual cash outflows, in order to separate what we view as financing of these obligations and investing of acquisitions/disposals from the operating cost component. Earnouts When an insurance broker acquires a target, sometimes it structures the deal by paying part of the valuation up front funded by cash on hand, equity interests, or debt. The unpaid amount is a stream of contingent future profit-sharing payments shared with prior owners over a specific timeline known as earnouts. Essentially, the latter acquisition costs are self-funded by the acquired units by means of earnouts, assuming profitability. Acquirers contend that this contingent earnout structure is an effort to mitigate the risk of earning deterioration by the acquired target during the post-acquisition transition period. These payments are not contingent on future employment, but rather maintaining customers. In practice, the acquirer shifts the payment responsibility to the acquired units rather than raising debt, sharing equity or using cash on hand. Because Standard & Poor's recognizes that contingent future profit streams are not available to service debt, when material to our analysis, we reduce operating cash flow and EBITDA by earnout payments. In the context of analyzing a firm's earnings potential, we include earnouts in operating income. The probability of an insurance broker paying earnouts that are contingent on future performance is relatively more likely than other industry players, as a broker transplants acquired producers to established hubs, shuts down the acquired target's shop effectively eliminating real estate expenses, forgoes acquired administrative staff, and expands productivity through a more sophisticated enterprise, with a caveat of maintaining the acquired book of business. Conversely, it is less likely that other industries actually pay earnouts to the prior owners of the acquired targets due to different industry fundamentals. Thus, Standard & Poor's factors in the likelihood of an acquired unit's contingent profitability in our analytical treatment of earnouts. To be fair, we also recognize the ultimate level of success of firms that successfully grow its enterprise through acquisitions. Goodwill impairment write downs Standard & Poor's considers goodwill impairment write-downs as noncash like and adds this figure back to earnings. On a qualitative level, goodwill impairments may, particularly when specifically assigned to a specific acquisition, signal above-average operating risks as well as unsatisfactory due diligence practices. Insurance brokerage is a relationship business, and often, acquired brokers control a book of business. In the event of even a few highly productive brokers leaving the target company post acquisition, the earnings streams can be materially impaired as a result. To avoid this event, acquirers impose nonsolicit and noncompete arrangements upon acquired producers, and fund part of the acquisition cost through earnouts (see previous paragraph). In some states (e.g., California) nonsolicit and noncompete arrangements are difficult to enforce. Noncancelable operating lease and retiree benefits The noncancelable operating lease adjustments are performed for all companies. Retiree (pension and other post-retirement) adjustments are performed for companies with defined benefit obligations. Most insurance brokers that are speculative-grade do not have defined benefit obligations. These adjustments affect all ratios. The implicit lease and retiree interest expense and unrecognized retiree service costs affect coverage metrics and margins. The net premium value (NPV) of lease payments (using a weighted average cost of debt or a 10% default discount rate) and the tax adjusted unrecognized retiree obligations are considered debt-like and are added to total obligations. For more information please see the following articles in Ratings Direct: "Insurance Broker Criteria: Explicitly Incorporating Non-Cancelable Operating Leases Into the Financial Analysis," published July 28, 2004, and "Criteria: Standard & Poor's Encyclopedia Of Analytical Adjustments For Corporate Entities," published July 9, 2007, under the chapter "Postretirement Employee Benefits/Deferred Compensation." Hybrid Debt Hybrid instruments have some characteristics of debt, and some of common equity. The more weight the latter carries, the more equity content we attribute to the instrument. We classify corporate hybrids' equity content as minimal, intermediate, or high. Analytical treatment summary: For hybrids in the intermediate category, we calculate ratios with the amounts split 50/50: One-half of the principal is categorized as debt and one-half as equity; one-half of the period payments is treated as common dividends and one-half as interest. (There is no adjustment to taxes.) This set of ratios is used as the basic adjusted measures, and these are the ratios we publish. Hybrids with minimal equity content are treated entirely as debt for ratio purposes. (i.e., generally, the maximum allowance is 15% of total capital, which is further reduced by 50%.) Hybrids with high equity content are treated entirely as equity for calculating ratios. Unpaid dividends that have accrued, prior to payment date, are viewed as debt--even for equity-like securities. For more information, please see the following article published in Ratings Direct: "Criteria: Standard & Poor's Encyclopedia Of Analytical Adjustments For Corporate Entities," under the chapter "Hybrid Instruments." Unique Insurance Broker Stand-Alone Metrics Discussed below are unique stand-alone financials used to evaluate the financial strength of insurance brokers. Organic revenue In order to assess an insurance broker's operational capabilities and quality of personal relationships, we look closely at organic revenue growth rates. Standard & Poor's defines organic revenue as same store brokerage commissions and fees excluding the impact of acquisitions and divestments within the last 12 months, foreign currency translation gains/losses, and market remuneration/contingent commissions. Standard & Poor's may report organic revenue figures that differ from company reports due to a wide variance of computation methods. Market remuneration revenue Insurance brokers collect market remuneration, an additional source of revenues for services that are already conducted. Brokers' margins may compress without market remuneration revenue since there is very little or no matching expenses. We've seen market remuneration come in different forms, namely contingent commissions, supplemental commissions and a 2.5% fixed fee in the U.K. market. Whatever popular acronym market remuneration is renamed these days, achieving market remuneration without losing clients, however, will help brokers become more profitable. Unrestricted cash and fiduciary funds Insurance brokers collect premiums from clients and hold this cash in a fiduciary capacity, typically in a regulated bank account. These fiduciary funds are shown on the balance sheet as both assets and liabilities. Brokers are not allowed to use fiduciary cash to service debt or for other corporate purposes. After a deemed period of time, the broker transmits these funds to the insurer. In the interim, brokers earn investment income on these fiduciary funds. In addition, insurance brokers report increases/(decreases) in fiduciary funds in cash from operations as a component of changes in working capital. Thus, cash from operations alone is not a sufficient indicator of unrestricted cash generation. Most brokers also separate unrestricted cash and cash held in fiduciary funds on its balance sheet. If this information is not provided, the Standard & Poor's analyst asks for this break-out information. Table 4 Financial Statement Values, During Property/Casualty Hard Market THREE-YEAR (2004 TO 2006) MEAN (MIL. $) BBB BB B INCOME STATEMENT ITEMS Revenue 7,963 488 169 Brokerage commissions and fees 4,646 455 161 Brokerage contingent commissions 116 24 6 Net income 523 12 11 Book EBITDA 1,150 86 39 Adjusted EBITDA 1,355 81 42 BALANCE SHEET ITEMS Unrestriced cash 852 22 19 Debt 2,687 258 181 Tangible net equity (647) (91) (144) Intangibles 4,645 484 208 CASH FLOW ITEMS Adjusted cash from operations 804 61 22 Free cash flow 576 50 10 Table 5 Organic Revenue Growth Peer Analysis HISTORICAL UNDERLYING REVENUE GROWTH MARSH & MCLENNAN COS. INC. 2007 2006 2005 2004 2003 2002 2001 Risk management and insurance brokering (%) (1.0) (2.0) (13.0) (6.0) 13.0 16.0 9.0 Reinsurance brokering and services (%) 1.0 5.0 (4.0) 3.0 21.0 21.0 13.0 Risk capital holdings (%) (16.0) 7.0 13.0 9.0 N.A. N.A. N.A. Discontinued insurance services (%) N.A. N.A. N.A. 12.0 5.0 6.0 12.0 Total risk and insurance services (%) (1.0) 0.0 (11.0) (2.0) 13.0 15.0 10.0 HISTORICAL ORGANIC REVENUE GROWTH AON CORP. 2007 2006 2005 2004 2003 2002 2001 Brokerage-Americas (%) 5.0 3.0 5.0 0.0 9.0 N.A. N.A. United Kingdom (%) 0.0 (2.0) N.A. N.A. N.A. N.A. N.A. EMEA (%) 4.0 2.0 N.A. N.A. N.A. N.A. N.A. Asia-Pacific (%) 2.0 5.0 N.A. N.A. N.A. N.A. N.A. Brokerage-International N.A. N.A. (1.0) 3.0 11.0 N.A. N.A. Reinsurance (%) 2.0 3.0 (5.0) (4.0) 10.0 N.A. N.A. Discontinued insurance services N.A. N.A. N.A. (13.0) 0.0 N.A. N.A. Total risk and insurance brokerage 3.0 2.0 1.0 0.0 9.0 12.0 8.0 HISTORICAL ORGANIC REVENUE GROWTH WILLIS GROUP HOLDINGS LTD. 2007 2006 2005 2004 2003 2002 2001 Global 0.0 8.0 (4.0) 3.0 17.0 18.0 16.0 North America 1.0 7.0 1.0 3.0 13.0 17.0 7.0 International 8.0 8.0 4.0 9.0 15.0 21.0 14.0 Total Broker Revenues 3.0 8.0 5.0 4.0 15.0 18.0 12.0 N.A.—Not available. Data based on SEC filings These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by the issuer-specific or issue-specific facts, as well as Standard & Poor's assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions change from time to time as a result of market and economic conditions, issue-specific or issuer-specific factors, or new empirical evidence that would affect our credit judgment.