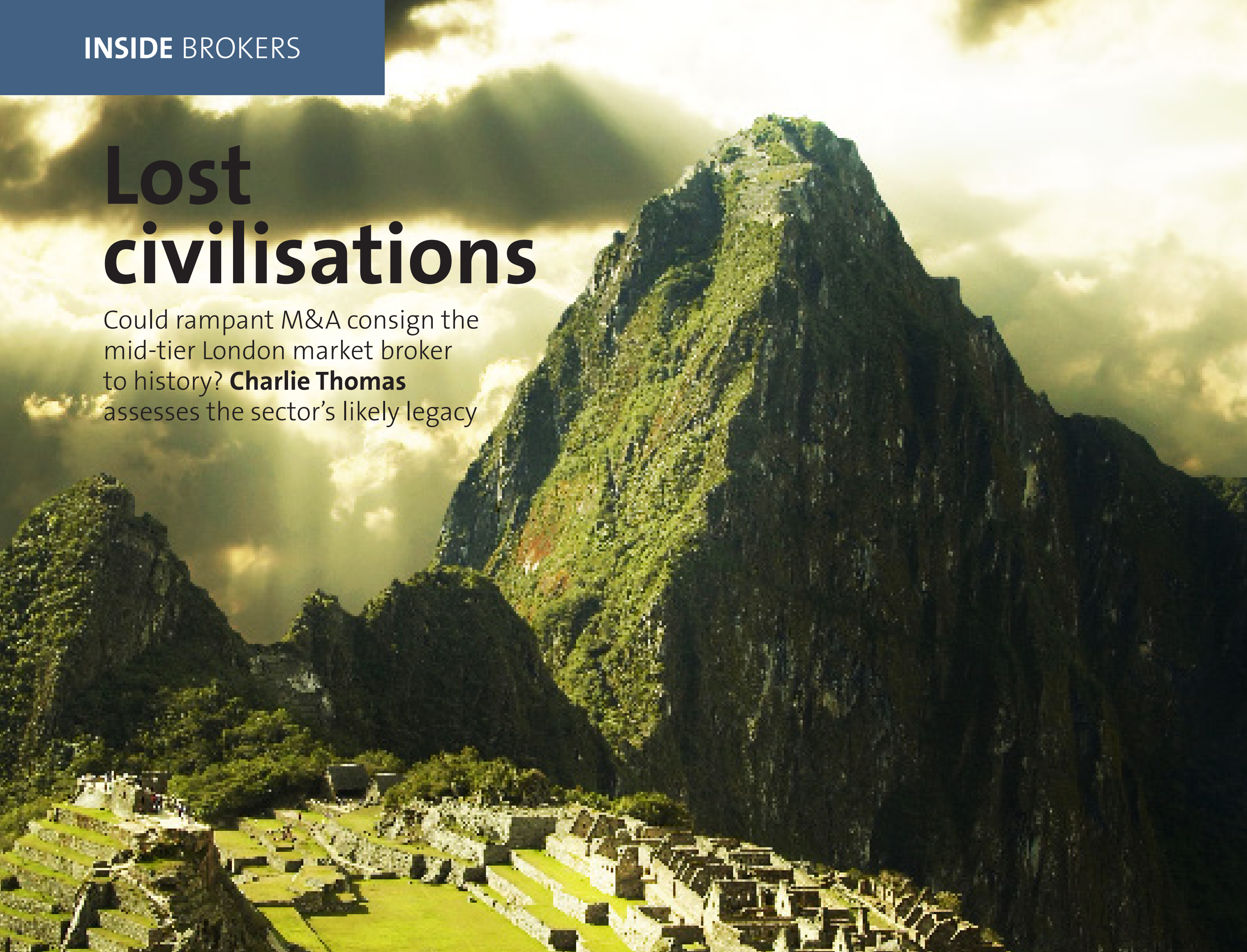


Lost civilisations

Could rampant M&A consign the mid-tier London market broker to history? **Charlie Thomas** assesses the sector's likely legacy

It's not often that the London broker market is compared with the ancient Incan civilisation, but believe it or not, the parallels are there.

Once upon a time, there were two Incan factions fighting for control of a huge amount of money, power and the adoration of everyone around them.

Two brothers led these two factions. One was named Huáscar, who was the established incumbent, physically bigger and on paper the rightful recipient of the gold, power and adoration. However, he was largely recognised as bit of a tyrant likely to refuse offers of allegiance – and a bit pompous and arrogant, to boot.

The smaller, nimbler brother, Atahualpa, was less well known, but loved by those he worked with. He was also recognised to be superior when it came to strategy, cunning and dexterity. See where we're going with this?

Much like Atahualpa in 1529, mid-tier brokers are feeling the squeeze in 2015. The Incan prince had to deal with armies invading his land, imprisonment and his messengers being sent back to him dressed as women (true story) in the run-up to the great Civil War that marked the beginning of the end of the Incan era. Mid-sized intermediaries may be facing less deadly troubles, but they could result in great pain for their market – and perhaps a completely changed broker landscape.

Most of the problems are not new. Indeed, a quick look at the opening paragraph for a feature on the mid-tier broker market in 2010 ("Grow your own way", *IQ*, summer 2010) could well have been written today:

"Here is a problem for London. EC3 relies on brokers to bring business, but today's global broking community inhabits a post-consolidated world in which most meaningful, mid-sized players have been absorbed and a top table of three global brokers is firmly established."

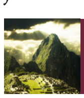
Fast forward to 2015 and the M&A trend has accelerated. Back in 2010, AJ Gallagher had bought FirstCity for $32mn, while Marsh picked up HSBC Insurance

Brokers for $130mn. In the past 12 months we've seen Hyperion acquire RK Harrison to create a "super independent", Miller get bought up by big three broker Willis, and others, such as RFIB, invite private equity into their business to improve their scale.

Ultimately, the pressures of being a smaller player are driving these deals. These include, firstly, the burden of regulation. In 2010, the UK Financial Conduct Authority had only just taken on the brief for regulating insurance brokers, and five years later the cost of complying with the rules around client money, conflicts of interest and more are spiralling. Besides this, in no particular order, there is the fact that the big three brokers are setting up ever more facilities to sweep up treaty money, the mid-tier market's continued lag with technology, and the need to become more global in order to remain relevant.

Despite these heavy burdens, the future for brokers that are willing to fight to retain their place looks bright. There is an abundance of capacity sloshing around EC3, and not all insureds wants to go with the big three brokers. There are ways to survive, and even thrive, in 2015.

Like Atahualpa, these intermediaries must take advantage of their positive reputation, their ability to be nimble and a superior strategy to see off competition from the bigger global brokers – and here, *IQ* reveals the top six ways to do just that.



BUY OR SELL OUT

It may seem a bit negative to dive straight in with giving up your independence, but increasingly for the mid-tier market (which we're classifying as approximately £25mn-£100mn in terms of revenue), it appears that if you're not looking to acquire, you're

Frank Murphy – CEO, THB

effectively up for sale.

The first key part of the strategy is to work out which end of the spectrum you are – or to quote one of the broker CEOs *IQ* spoke to: "You need to work out if you're a shark or a fish."

What's changed from five years ago is it's no longer just the big

"You need to work out if you're a shark or a fish"

three brokers using M&A as a way to prop up revenues when organic growth stalls. Now we're seeing a push to find the right partner, both culturally and financially, to pair up with – usually using money from the private capital markets.

"Families are being formed right now, and you need to pick your family before someone else picks you," says Frank Murphy, CEO of THB. "We've got a dual-pronged attack at the moment: make acquisitions where they make sense, and pick up disaffected teams from others who have merged."

Despite the recent rush of deals, most brokers think more are on the horizon. John Lloyd, CEO of JLT Specialty and former CEO of wholesaler Lloyd & Partners, said that further consolidation was inevitable.

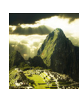
"The reality is if you'd asked me five years ago whether any of the deals that have taken place recently would have happened, I'd have said it was very unlikely, but these passionately independent firms clearly felt they had to do something," he says.

Stephen Skeels, valuations partner at Mazars, also believes that the recent UK general election result will lead to more M&A transactions, as the stabilising effect of having a majority leadership in charge of the country is beneficial from a macroeconomic point of view.

"We certainly had a conversation with a client who's thinking about selling up, [but] who wanted to wait to see what the environment would be like [post-election]," he says. "The likelihood is if Labour had got in, backed by the Scottish National Party, that would have made life a lot more difficult in terms of economic confidence."

A word of warning for would-be buyers and sellers, however: Skeels says that the multiples being bandied around for brokers are starting to look frothy.

"We've had quite a long period of 1.5x to 2x revenue and 5x to 7x Ebitda, but now it's more like 2.5x revenue and 12x Ebitda," he says. "Once you start looking at 12x Ebitda, it becomes unsustainable. To make that pay, you've got to grow so quickly to get the return, and to do so organically is tricky, so you put yourself on a conveyor belt of growing by acquisition."



BRING IN INVESTORS

The second option, if M&A doesn't suit your particular brokerage, is to consider inviting in private equity backers to swell your coffers.

Insurance – and here's a phrase I never thought I'd write – has become sexy, as far as private equity money is concerned. As BMS CEO Nick Cook notes: "We just haven't seen trade and private

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equity acquisitions both being as hungry as each other before."

BMS, as readers of sister publication *The Insurance Insider* will remember, agreed to sell a minority shareholding to US buyout firm Capital Z in May 2014, using the cash injection to expand both the broking business and the underwriting activity of its Pioneer managing general agency.

Capital Z has previously invested in UK brokers SBJ and Jelf, while its past underwriting stakes include John Charman's corporate Lloyd's vehicle Tarquin, class of 2001 Bermudian Endurance, 2005 start-up Lancashire, UK protection and indemnity insurer British Marine, PXRe and Catlin.

Speaking about the decision-making process BMS went through last year, Cook says finding a capital partner was essential due to the reality of needing more capital to cover the increased cost of regulation, obtain the scale to compete with the big three brokers, increase its distribution and diversify its lines.

"We didn't want to take on debt and didn't want a trade sale as we saw that there was still an opportunity to grow, so we opted for the long-term view with Cap Z," Cook explains.

Others were less positive about whether private equity was the right route. JLT's Lloyd describes it as "selling your soul to the

Nick Cook – CEO, BMS Group

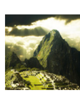
Michael Donegan – CEO, Price Forbes

devil", given that "private equity always requires an exit". Mazars' Skeels also talks about a "bubble building" in the broker space, meaning that in a few years' time some private equity owners may feel that they overpaid, and will seek a quick exit.

Having said that, Skeels is adamant that there remains a

> "Brokers will have to relinquish their control of the data, If they keep their head in the sand about this, the world will pass them by. Business is moving on, and they need to evolve or get left behind"

huge amount of interest from PE houses, not only to help existing brokers grow but also to boost the coffers of those seeking a management buyout or to launch a start-up.



TECH UP

One area where Willis, Aon and Marsh have taken advantage of their size and resources is technology. Cat modelling, analytics and big data were once considered a differentiator, but now are increasingly seen as a must-have for anyone looking to compete.

"Technology is vital. We've got to be quick, we've got to be slick, but we've also got to be at the forefront of governance," remarks Barnaby Rugge-Price, CEO of RKH Specialty.

JLT's Lloyd is one of many brokers who support the development of a single market platform, adding: "For the first time it looks like there will be a consensus to arrive at something which will drive efficiency into the marketplace."

Besso chairman Colin Bird goes a step further, and insists that if insurance is to remain relevant in London it's got to recognised that most of the business could be commoditised.

"Brokers will have to relinquish their control of the data," he says. "If they keep their head in the sand about this, the world will pass them by. Business is moving on, and they need to evolve or get left behind."

It's a topic that Michael Donegan, CEO of Price Forbes, feels passionately about too. While he's in favour of market-wide initiatives to try to commoditise elements of placement and claims systems, he remains sceptical about whether they will be able to do the job as well as assigning the job to a real person.

The Electronic Claims File (ECF) service is a case in point. Price Forbes uses it, but Donegan says he can't rely on the service to pay his clients "or we wouldn't have any left".

"Our brokers still have to negotiate the claim and get it paid, which at the end of the day is what clients hire us for," he continues. "The ECF proves that IT only goes so far; transmitting paper is only half the story."

Outsourcing elements of the tech question could be part of the solution. Many firms have introduced a form of internal outsourcing where the broker hires staff that work in a satellite office, either elsewhere in the UK or, often, in India. But brokers must determine whether the cost savings are worth the potential loss of control – something many said they were still investigating.

BECOME GLOBAL

The fact that more policies are being written overseas by domestic insurers (and are being placed by domestic brokers) has risen up the agenda recently.

London brokers have desired footholds in up-and-coming regions such as Singapore, Zurich, China and Latin America for some time, but now it's become more of a need than a want. And simply having a few people on the ground isn't enough – overseas marketplaces need proper resources.

This is part of what several people described as a fundamental change in how insurance broking is carried out. Traditionally, the model was that London brokers travelled to a region and brought it back to EC3, but now there's much more business being done through joint ventures and building regional hubs.

The attention called to this change by the London Matters report, written earlier this year by the Boston Consulting Group and the London Market Group, has made that need more acute.

"Inga [Beale, CEO of Lloyd's] has got the right idea about making sure Lloyd's remains relevant, but she's got a tough job ahead of her to try to develop the business," says THB's Murphy. "She's got a difficult line to walk in not upsetting the distribution chain both here and in other territories.

"We as brokers have to grow up and realise that even if we don't like it, more business is staying locally, and if we don't go and bring it back, Lloyd's will have to go and get it."

Others believed that while the importance of overseas markets will continue to grow, once the bottom of the soft market has been reached business will return to London – even in the challenging area of wholesaling.

JLT's Lloyd was one such advocate, saying: "Of course London has a diminishing share of the pot, but a smaller share of a bigger pie doesn't mean London's becoming irrelevant. People talk about the London Matters report as though we should be on suicide watch. I'm not criticising the report, but the paranoia which is surrounding it."

BECOME A SPECIALIST

The question of whether mid-tier brokers could survive simply by offering some niche specialisms within their business lines was a complicated one for the market to answer. Some, like BMS's Cook and Besso's Bird, feel that diversification is key to mid-sized brokers' survival, and that small specialists will either get swallowed up in a trade sale or will struggle to make ends meet in these times of pressured margins.

Others felt that by concentrating on what mid-tier brokers do best – providing bespoke, individual placements and policies for clients in specialty areas – they could beat off the competition from the big three brokers and would be

Colin Bird – chairman, Besso

John Lloyd – CEO, JLT Specialty

rewarded with their customers' loyalty, even if they chose to write across only a few lines.

Price Forbes' Donegan was told in the 1990s that the days of a niche broker were dead and that the future was all about global players. More than 20 years on, he thrives on his firm being an independent specialist that its clients depend on.

"The smaller broker is more willing to 'think outside of the box' on behalf of a client. We're more prepared to design a programme around their needs, rather than presenting them with one we've already designed. That's what clients want, they want to feel listened to," he stresses.

RK Harrison's Rugge-Price says the future of the combined Howden and RK Harrison super-independent will be in specialty broking. "We must have industry and product expertise allied to the best broking resource," he says.

"As an example, what was a general casualty business has evolved into a series of niches within the broad umbrella of casualty – healthcare, product recall, D&O, E&O and so forth – and as the risk evolves, so the cover has to."

And, as has always been the case, the mid-tier broker must offer exemplary service. While clients want an element of choice in the broker market, if the service they receive isn't up to scratch there's no reason why they

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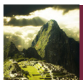
wouldn't choose Aon, Marsh or Willis instead.

Finally, service means that brokers must offer in-house analytics, cat modelling and/or meaningful data to secure loyal custom – something that, as highlighted earlier, almost all of the mid-tier specialists agree is now imperative.



SUCCESSION PLANNING

Whether your brokerage intends to remain independent or whether it is lining up for an M&A deal, succession planning is key. Traditionally, the broking sector both in general insurance and the London market has been poor at planning for the future.

Partly, this comes down to how senior executives have become leaders at these intermediaries. Most have been good producers who have found themselves promoted into the upper echelons of the boardroom and have had little or no management training.

Mark Grice, partner at Mazars, speaks for much of the industry when he remarks that while most brokers believe they have succession plans in place, how they are executed is another matter.

"Fundamentally, this is about wealth generation for most of these people – you don't make your fortune by being in the big three brokers, you do it by building your business, growing and selling it. If you're lucky, you'll do that two or three times in a career," he says.

The need to sell up at the right time, returning to the first step in our survival strategy, is precisely why succession planning is so important.

The situation is the same for private equity partners, which will often insist on a fully detailed three and five-year plan.

With so much on the line, many brokers and financial backers won't entertain getting into a transaction with an intermediary unless there are firm plans for the management once the deal has been completed.

> "Already, people are talking about the £50mn-£100mn space being ripe for development following Miller's takeover by Willis"

"We've seen the issue across the market, but particularly in London and the wider market, and it's tough to plan for," says RK Harrison's Rugge-Price. "Answering that question successfully will be the key to making these M&A deals work."

THB's Murphy agrees, saying there has to be a "seamless" transition between the old management and those coming through before his firm would even consider partnering with another.

One last area we asked interviewees to ponder was what they thought the landscape would look like in five to 10 years' time for the mid-tier broker.

Most thought the number of brokers would be about the same, perhaps slightly fewer, but the names would be different. As each new takeover or merger completes, it creates a gap in the market that the next ambitious wannabes will aspire to fill, whether through organic growth, their own M&A or through private financing. Already, people are talking about the £50mn-£100mn space being ripe for development following Miller's takeover by Willis.

Barnaby Rugge-Price – CEO, RKH Specialty

Most also agreed that the number of managing general agencies will increase, and that there will be fewer pure London market wholesalers.

But the overriding message was that the future was bright for mid-sized brokers because clients would always want that element of choice, the bespoke programmes and the closer client relationship that a mid-tier broker provides.

This is a darn sight better than the future that faced poor old Atahualpa. When the Spanish arrived in South America, he decided to let conquistador Francisco Pizarro choose which brother should rule the Incan empire, and offered to ride out to meet him.

Atahualpa however, became paranoid ahead of the meeting, and decided to murder his brother rather than risk being placed runner-up. His reward was to be garrotted by Pizarro's men a few months later. And thus the decline of the Inca Empire began, brutally hastened by a host of European-borne diseases such as smallpox, diphtheria and influenza.

There may be something of a lesson for mid-tier brokers here. It was an external threat in the form of Pizarro that ultimately did for the Incan empire, so perhaps mid-tier players should look to external threats to their industry, such as the threat of disintermediation, instead of focusing on the pressures from the big three brokers.