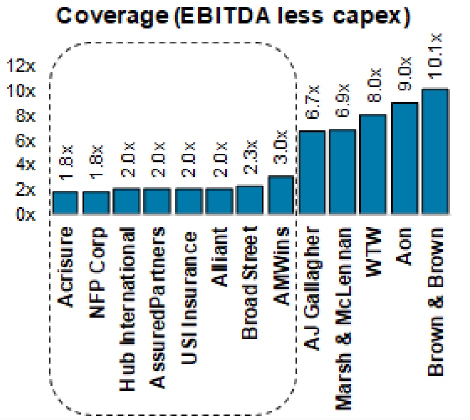
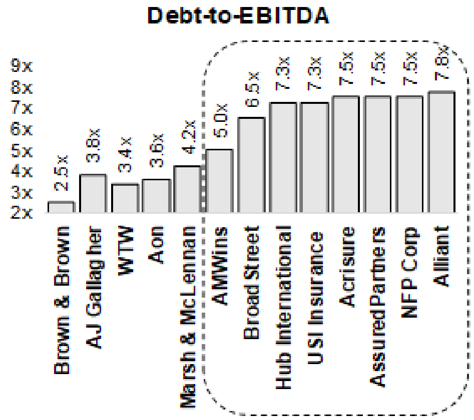
A Black Swan Moment For Levered Roll-Ups





There are lots of ways to fail with a bad business. The P&C universe is filled with multiple, and endlessly creative examples. But with a good, growing, and cash generative business, about the only way you can really screw it up quickly beyond repair is with leverage.

Insurance brokerage is a "good" business. A typical insurance broker is hardly capital intensive but cash-rich and under-regulated enterprise with controllable margins and fairly predictable cash flows. It has limited underwriting or asset risk exposures. These features keep the brokerage business relatively safe from tail risks and exogenous shocks.

But over the past few decades, it has built out a growing leverage problem. Built on the success of KKR's recapitalization and IPO of Willis in 2001, the influx of copycat private equity money has turned the space into a debt-fueled ever-consolidating realm.

The path and duration of the current crisis is fundamentally unknowable. However, our view is that should the duration prove prolonged, it is likely to cause significant cash flow problems at insurance intermediaries, as (a) exposures are rebased (b) regulators force premium rebates, and (c) payment grace periods and/or bad debt levels on premiums due increase.

Of course, not all insurance intermediaries are created equal. Companies differ both on their business mix and revenue exposures to more impacted lines, and their financial leverage. Large public brokers with diversified businesses, strong balance sheets, and easy access to capital markets are likely well positioned to weather even a significant stress scenario. However, due to the increased level of leverage at "roll-up" entities, our view is many companies are entering this period with elevated financial risk.

We view current economic conditions manifesting as a potential "out of sample" problem the highly levered roll-up model has not anticipated, comparable to the mortgage crisis for banks in 2008. The longer this period goes on, the more of a stress test it will prove – including even a sustained period of impaired growth with the economy partially open.

Finally, even without liquidity problems becoming solvency issues, the spike in fixed income yields may further challenge the debt-reliant businesses and change the model of consolidation across the industry.

More details below.

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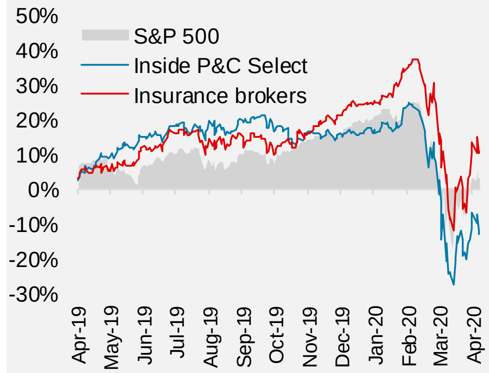
Composite	YTD px chg.	P/B
Large comm.	(35.6)%	0.7x
Regional	(23.1)%	1.3x
Specialty	(23.1)%	1.4x
Personal	(1.9)%	1.9x
Bermuda	(32.7)%	1.0x
Florida	(31.3)%	0.9x
Brokers	(10.7)%	-
IPC Select	(25.6)%	1.0x
S&P 500 Fin.	(31.0)%	-
S&P 500	(13.3)%	-

Top performer on the day	STFC +3.7%
Bottom performer on the day	AFG -4.5%

1YR Price Peformance

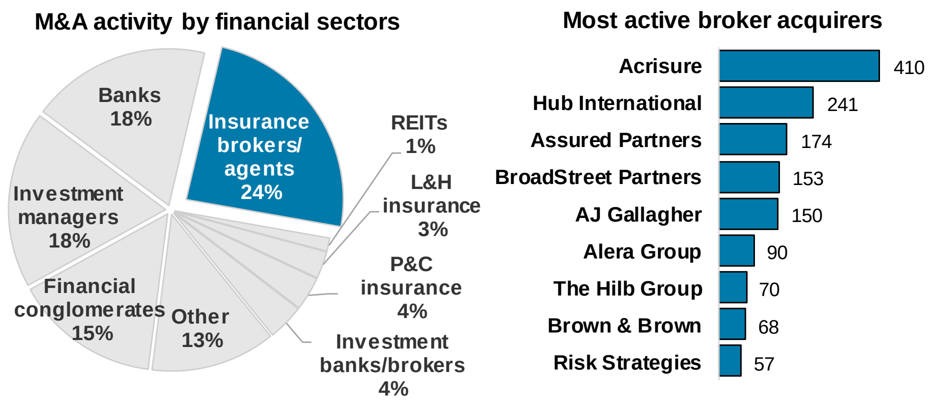


A black swan stress test for leveraged roll-ups

There are now north of 20 major PE-backed roll-ups in insurance brokerage (some market participants place it north of 40 for smaller entities). Investment bankers cite over 500 M&A transactions last year alone. Leading roll-ups of the last five years include Acrisure, Hub Imanifnternational, AssuredPartners and BroadStreet Partners that together do more than 200 transactions a year, implying almost an acquisition per business day. It is simply inconceivable that relatively small organizations can have the bandwidth to make acquisitions at this pace and exercise real due diligence on business quality.

Exhibit: M&A statistics covering the past five years

Source: FactSet, Inside P&C



Simply put, these organizations are based on financial engineering. They are betting they can buy earnings at cheaper multiples than they can sell the sum-of-the-parts, and using leverage to amplify their returns. Additionally, they have tax amortization benefit since under US tax law amortization of goodwill is tax-deductible.

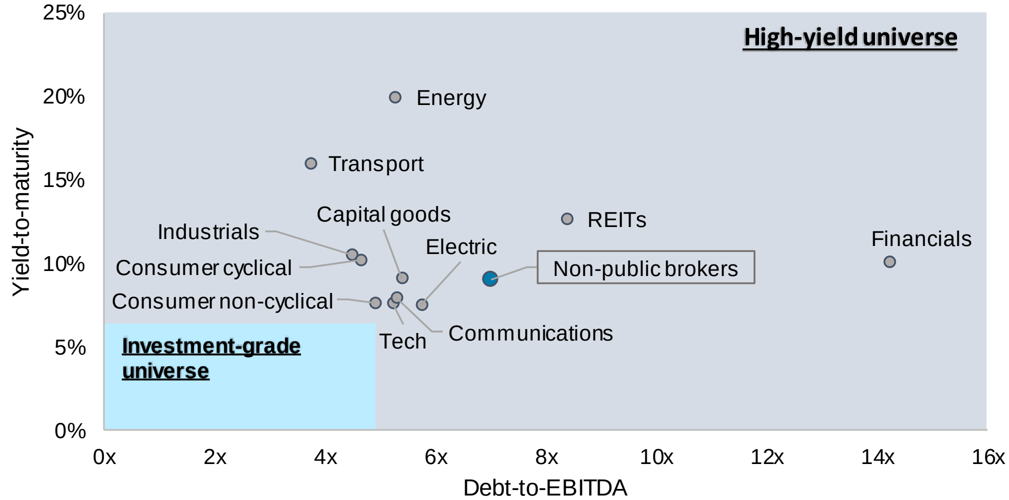
Lenders have been willing to extend credit at higher and higher levels of leverage in part due to low interest rates and private savings glut relative to supply. But it is also partly premised on the idea that brokerages (a) sell a mandatory product that is not subject to obsolescence risk or taste changes, (b) have empirically proven high levels of stickiness (low switching risk), (c) can sustain higher leverage due to relative stability of operating cash flows and (d) have defensive revenues that have held up in recessionary environments.

Recall, last year and earlier this year, we highlighted the growth of leverage in the sector and argued it was becoming more vulnerable to economic slowdown. Since the introduction of social distancing measures, we have started to view the emerging economic turmoil as a potential “black swan” event that could challenge the business model should the economic slowdown prove prolonged.

Today, the US non-public brokers that we have available financial information on are among the highest levered issuers in the debt market, running debt levels at an average 7x EBTIDA. The number is higher than in all industries outside financials and REITs, the businesses that run on interest rate spreads and mortgage financing (= designed to operate at a high leverage).

Exhibit: Yields-to-maturity vs leverage ratios for high-yield issuers by sector average

Source: FactSet, Inside P&C



Similar to the "out of sample" problem that led to mass solvency issues among banks that had not modeled for a nationwide collapse in housing prices at the levels seen in 2007/2008, the level and pace of slowdown of economic activity is likely to provide an intense stress test to the financial strength of insurance intermediaries if it persists.

In short, this is an exogenous shock that is likely to act as a severe stress test on parts of the insurance intermediary business and the assumptions it has been predicated on.

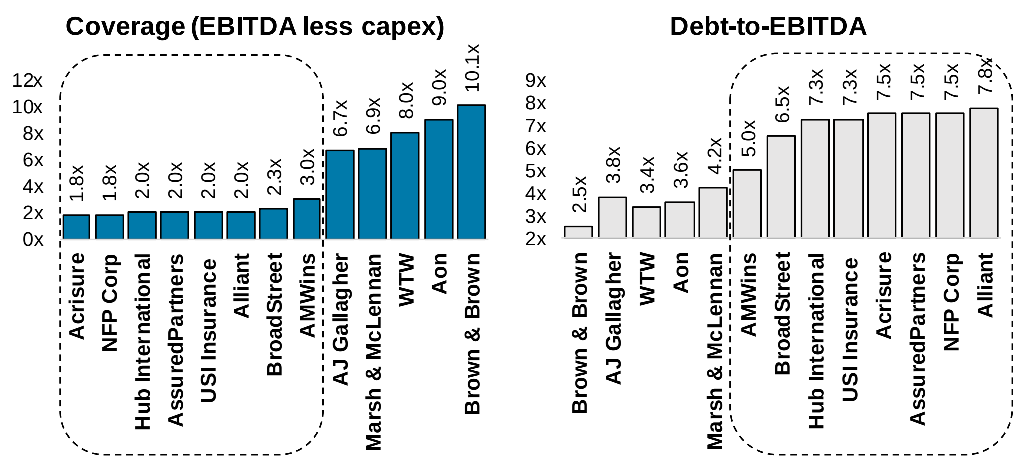
The outstanding question is whether leverage will lead to good businesses suffering the same fate as the proverbial 6ft man who drowned crossing a river that was 5ft deep "on average". We see three key issues in play.

First, many brokerages entered this period at a time of peak financial risk.

As we highlighted back in September, most non-public brokers are currently operating at an "all-in growth" mode, mounting balance sheet debt, forgoing integration work, sacrificing earnings and spending substantial cash flow on interest expenses.

Exhibit: Coverage and leverage ratios by brokers

Source: Company reports, Moody's Investors Service, S&P Global Ratings, Inside P&C



Debt investors typically place a lot of concern around so-called "crossover" risk, i.e. the risk of debt falling to a "speculative" category below triple-B. The fall below the triple-B rating means substantially higher financing costs, less access to funding and reputational risks often forcing such companies to shift strategies. However, these would be "high quality problems" for the non-public brokers that are rated five to six notches below the investment-grade category. For them, a downgrade could mean an explicit existential threat due to a lack of access to financing. Seven out of nine non-public brokers with credit ratings available are currently rated at B3 by Moody's (B-equivalent), a notch away from the "extremely high risk" category.

To assess how much headwind the brokers can tolerate without being downgraded to the risk category just above default, we placed their current debt-to-EBITDA measures against the downgrade scenario, which we conservatively estimate at 8x, in line with 7.5x-8x of the typical downgrade case for B3 rated brokers communicated by Moody's in the latest broker rating reviews.

In this exercise, we modeled for the tolerable organic revenue contraction capping the leverage at 8x EBITDA. We also assumed travel and expenses (T&E) of 5% of operating expenses, all of which can be cut, and 80% fixed costs reflecting that a significant portion of insurance broker operating expenses are fixed (and even more so at public brokers).

Exhibit: Maximum tolerable annual revenue contraction to maintain B3/B- rating

Source: Moody's Investors Service, S&P Global Ratings, Inside P&C analysis

	Ratings				
	Moody's	S&P	Revenue*	Debt/EBITDA*	Annual revenue contraction tolerance (est.)
AMWins	B1 stable	B+ stable	1.3bn	5.00x	**-18.4%**
BroadStreet Partners	B2 stable	-	0.6bn	6.5x	**-10.3%**
Hub International	B3 stable	B stable	2.2bn	7.25x	**-7.9%**
Acrisure	B3 stable	B stable	1.5bn	7.5x	**-6.8%**
AssuredPartners	B3 stable	B stable	1.2bn	7.5x	**-6.7%**
USI Insurance	B3 stable	-	1.8bn	7.25x	**-7.8%**
NFP Corp	B3 stable	B stable	1.4bn	7.5x	**-6.7%**
Alliant	B3 stable	B stable	1.5bn	7.75x	**-5.7%**

*Based on Moody's TTM financials as of dates varying between 06/19-03/20. Debt/EBITDA are pro-forma if a firm is in process of a merger or debt offering

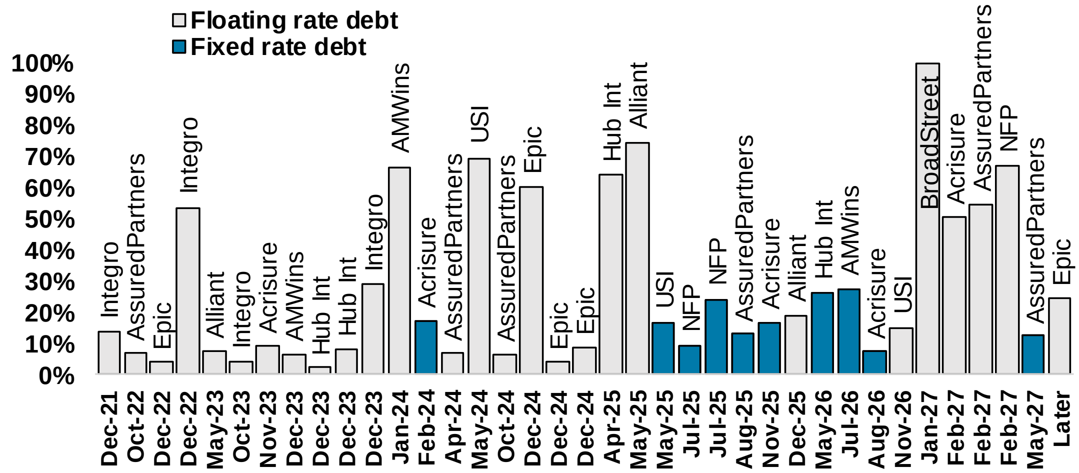
Under our assumptions, highest levered brokers can tolerate 6-8% contraction in the annual organic revenue, reflecting brokers' relatively high resilience to the topline headwinds. During the 2008-2009 recession, non-public brokers saw an average revenue contraction of 2%. However, should this downturn be steeper, the hardest hit brokers may fall far below the previous recession's average into the danger zone.

Of course, there are more factors to account for, e.g. coverage ratios, cash flow, qualitative factors, but given the limited data on the privately held companies, the simplified model works well to give a sense on the financial resilience of the firms against the topline headwinds.

On a positive note, the debt maturity schedules give some breathing room for the firms, as no broker (with publicly available financials) has above 15% of debt maturing until 2024. That excludes Integro with 45% of the debt maturing in the next 3.5 years. However, it is now part of Epic, a much larger firm with a much more favorable maturity profile (see chart below).

Exhibit: The schedule of maturing debt as a % of total outstanding debt

Source: FactSet, Inside P&C



Also, the fact that most brokers use revolving credit facilities and term loans that pay floating interest may partly alleviate some of the headwind in the short-term. Floating interest is typically benchmarked against LIBOR, the rate that banks use to lend money to one another globally. It typically moves alongside treasury yields that have been trending down since 2018 and bottomed in March, implying cheaper financing costs on the existing debt for floating rate debt issuers. However, LIBOR is significantly exposed to stressful environments. When there is a run on the banks and/or credit markets enter deep disarray with investors and financial institutions hoarding into cash, the cost of LIBOR-linked debt may grow substantially.

Potential wildcards include financing with any aggressive features in the event of default that could risk dilution to equity holders.

Second, the leveraged roll-up model is premised on defensive income streams. This premise is likely to face a stress test.

So far, the industry paradigm seems to hold in many segments. Pricing through April 1 appears to have continued unabated. Carriers continue to cut limit, and the only headwind to prior dynamics appears to be a little more willingness from clients to buy less. There seems to be little spillover in many segments from the economic shutdown to date.

But this is a fast-moving crisis, and insurance is a slow-moving industry. There are long lead times on negotiations and a fair amount of inertia built into the system. It's simply like an oil tanker that's hard to bring to a full stop on a dime.

That said, we see several potential sources of emerging stress that could act as a black swan event for a lot of main street focused agents across the US, many of which have been rolled up into highly leveraged entities. In particular, there are specific <u>cash flow</u> issues even where revenues are assumed to be less affected.

The primary source of strain is likely to be a re-base of exposures and therefore premium in-flows – and a potential for cash outflows based on commission reversals.

The primary source of strain is **workers' comp**. The latest unemployment claims data suggests that already north of 15% of the US workforce is likely unemployed. Credible estimates point to a risk of up to 30% unemployment should social distancing measures be necessary for an extended period.

Workers' comp premiums (~$55bn) are linked to payrolls. The precipitous decline in payrolls will force down renewal premiums and commissions. Cash starved companies may seek to pre-emptively negotiate down their premiums rather than wait for policy end for an audit/true-up.

Some states are already taking measures to return WC premiums to employers. Last week, California announced it expects steps from carriers on returning premiums associated with lower claims in connection with the pandemic. In another example, the Ohio Bureau of Workers' Compensation, the state-operated provider of WC insurance covering two-thirds of Ohio's workforce, announced its plans to return $1.6bn of premiums to public and private employers, which roughly equals the amount of premiums the state's employers paid to the bureau in full year 2018. This could not only lower cash flow in (lower renewal exposure base), but force cash flow out due to premium reversals depending on how much carriers protect their distribution partners.

A similar dynamic is in play in **personal auto** (~$230bn+ premiums in independent agent channel). Almost every major auto carrier has outlined plans for premium rebates to customers, largely in the 15-20% range for two months. Again, this will reduce cash flow in (monthly premiums) and could require reversals of prior commissions on pre-paid policies depending on carrier action to prevent their agents taking the pain.

Exhibit: Auto carrier refund announcements

Source: SNL, Company Reports

Firm	Refund/Credit	2019 Auto DWP
State Farm	25% credit on two months of auto premium	$40.9B
Geico	15% (for 6M policy) credited at renewal, totals $2.5B	34.9B
Progressive	20% credit on two months of auto premium	31.0B
Allstate	15% refund credited to customer, totals $600M	23.6B
USAA	20% credit on two months of premiums in coming weeks	15.2B
Liberty	15% refund on two months of auto premium	11.7B
Farmers	25% credit for the month of April	10.5B
Nationwide	One-time premium refund of $50 per policy	6.2B
AmFam	$50 payment per covered vehicle, one time, totals $200M	5.8B
Travelers	15% refund credited to customers (April / May)	4.9B
Kemper	15% credit on two months of auto premium	3.4B
National General	No refund/credit yet	3.2B
Mercury	15% credit on two months of premium	2.8B
Hartford	15% credit on two months of premium	2.0B
Hanover	15% refund on two months of premium	1.2B
Chubb	35% reduction for April/May, "with additional discounts for subsequent months, as the situation warrants"	0.8B
Cincinnati	15% credit on two months of premium	0.63B
Horace Mann	15% credit on two months of premium	0.45B

In small commercial, only a few companies have publicly announced policies related to premium rebates.

However, a handful of carriers are taking steps to provide concessions in various forms, implying further rebates is a high possibility. Moreover, California is targeting many lines expecting carriers to implement premium rebates including commercial auto, workers' comp, medical malpractice and any other areas with lower risk of loss due to the pandemic. This could lead to similar pressure on other states and P&C firms to follow, which may mostly hit independent agents that are overweight small commercial.

Exhibit: Commercial carrier actions

Source: SNL, Company Reports

Firm	Action (commercial lines)
Travelers	Billing relief (suspending cancellation/nonrenewal through May 15th)
Chubb	25% reduction in sales/payroll exposures used to calculate premium as well as a 15% reduction in premiums for comm'l auto insurance (for small business clients)
CNA	Until June 1, suspend all policy cancellations for nonpayment, waive all late fees, continue regular premium billings
Berkshire	"Could include: grace period to make premium payments, deferral of cancellation due to nonpayment, or waiver of late fees"
Nationwide	"…suspend the cancellation of some policies, defer payment deadlines, and waive some late fees"
Progressive	- Suspending cancellations/non-renewals on comm'l lines policies through May 15 - 20% credit, April/May for Business owner/GL
Farmers	20% credit for two months (BOP) in addition to extended time to pay

The second element is the growing willingness of some carriers to allow a "grace period" for premium payment.

This is motivated to show empathy to their insureds, particularly for those waiting for access to government loans.

Again, there is a risk that agencies without a strong balance sheet will be caught up in this payment delay – cash is to brokerages is what motor oil is to engines. The easy rejoinder to this is that it is just a liquidity issue and not a solvency one. Our view is that the longer that economic shutdown goes on, the more credit risk will apply to these accrued balances and the more liquidity risks spillover to solvency issues. The key known unknown is the likely duration of shutdown.

Finally, there are simply multiple other revenue and cash flow headwinds similar to other recessionary periods but likely much faster, from the loss of project specific revenue, to construction, energy, and surety to name but a few. We'd note that during the 2008-2009 recession independent brokers and agents shrunk by around 2%, and this slowdown is likely to be much, much steeper, even if the duration is as yet unknown.

If this sounds theoretical, we'd note that Travelers has already announced $100mn in advanced commissions to agents struggling with liquidity issues. Whatever the good intentions from Travelers (and this truly seems like an act of treating its distribution like partners), this seems like a fairly public "tell" of issues emerging away from public view.

Similarly, Progressive announced that it is "partnering with agent associations to provide direct relief through grants to help agents address the new challenges presented by the virus".

Our view is that there is too much optimism for an easy rebound to a *status quo ex ante*. Though we expect mean reversion over time is close to inevitable, we still expect an intermediate period between "shut down" and "normal again". This is likely to include a period of cooler economic growth likely due to restrained consumer demand across multiple dimensions and the potential for new outbreaks until a cure or vaccine is available – likely not for 12-18 months, according to health experts.

There are undoubtedly bull cases out there and more optimistic outcomes that could manifest, which would act as a get out of jail free card on liquidity. However, we expect this to play out as more than a one-and-done short-term exogenous shock that requires liquidity fixes only.

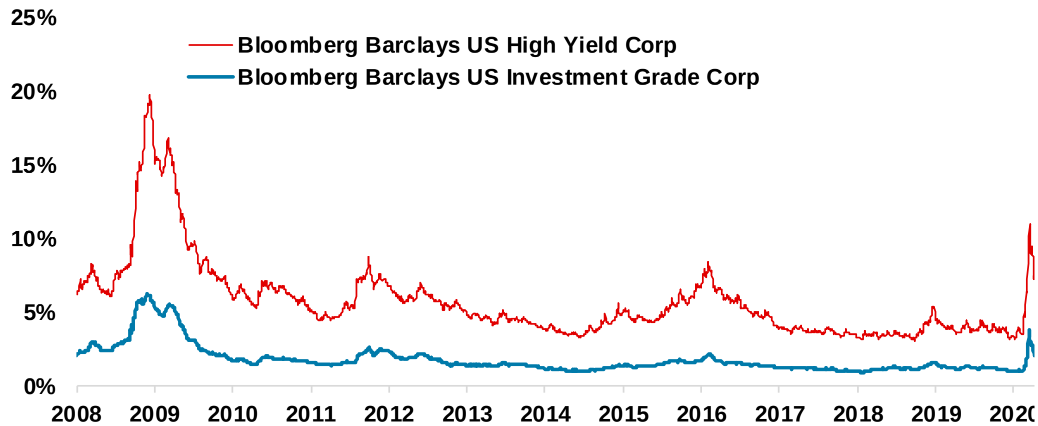
Finally, there is an increased threat to the business model from the growing cost of borrowing.

Since the crisis began, we have seen a spike in yields across the entire risk spectrum from high-yield to investment-grade corporate and municipal bonds. The yields picked up despite Treasury yields declining, implying a substantial expansion in credit spreads. The corporate credit spreads on both investment grade and high-yield bonds at one point spiked to the highest levels since 2009. Despite the yields cooled down following the Fed bond buying program, the stress in the high yield markets persist with the spreads showing significant daily volatility.

To note, only junk bonds that had an investment-grade rating before March 22 qualify for the extended Fed bond buying program, meaning no private broker's bonds are eligible.

Exhibit: The schedule of maturing debt as a % of total outstanding debt

Source: FactSet, Inside P&C

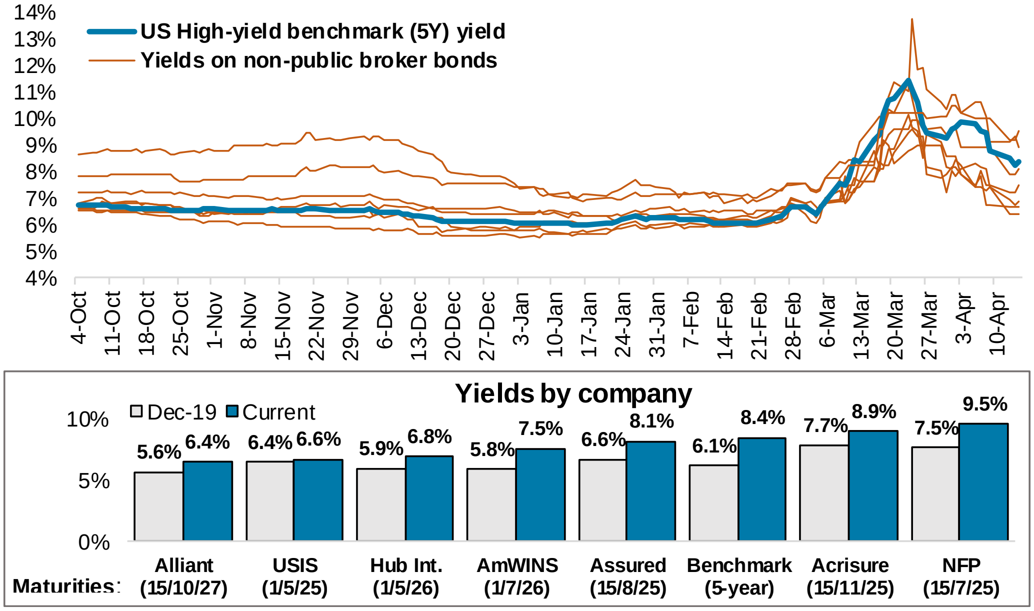


If the wide credit spreads persist coming out of the crisis stage due to the weakening of balance sheets and credit quality through the slowdown, it is likely to change the model of consolidation across the industry. Multiples paid are likely to come down due to higher cost of capital, and make the space more competitive again to more conservative and cash buyers. More conservatively capitalized public brokers with better access to new capital may be well positioned to take advantage.

Current yields on the existing broker bonds show that it is now up to 200bps more costly for some non-public brokers to raise new debt than at the start of the year (see chart below).

Exhibit: Yields on brokers' 5Y-7Y bonds

Source: FactSet, Inside P&C



Additionally, the downturn risks the private equity owners of some of the roll-ups, who bought high and may need to sell low to fill any funding gaps if access to liquidity dries up.

Again, this will likely depend on the duration of the crisis. Nearer term, they most likely have ample access to bank revolvers and the potential for government loans. But an extended downturn would challenge the ability of many to raise capital, with debt likely tapped out and equity unlikely to be raised without serious dilution to existing holders.

Of course, there are multiple caveats to all of the above.

Companies can limit cash outflows through downsizing staff. Termed out debt gives plenty of breathing room if the length of crisis proves steep but only short. It seems still fairly early days into a crisis with an unknown duration that could follow multiple different paths.

However, we think the premise that a few of these roll-ups have entered a crisis at a period of elevated financial risk is hard to deny, making them more vulnerable to negative outcomes if the crisis proves prolonged.

And, we find it hard to think of a scenario where the most levered companies (and their owners) and the payers of the highest multiples in recent times don't come out of this crisis with a worse hand than they came in – either through the negative impacts of recaps (worst case) or a period of deleveraging and an impaired growth model going forward (best case).

There is simply no "cure" that doesn't carry a high price other than an instant relief of biological and economic crisis.

This research report was written by Insider Publishing's Research team which includes Gavin Davis, James Thaler, Gianluca Casapietra, and Dan Lukpanov.

The content of this report includes opinions based on publicly disclosed financials and management commentary.