2023 Property & Casualty Insurance Brokerage Report

smythe

Contents

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1700 – 475 Howe Street
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smythecpa.com

Dear Readers,

This is the 9th Edition of the *Smythe Property & Casualty Insurance Brokerage Industry Report.* For well over a decade now, we at Smythe have endeavored to put together as comprehensive a report as possible on the state of the Canadian property and casualty insurance brokerage industry.

In this report, you will find an analysis of the data collected from our survey about current and emerging trends in the industry, as well as a snapshot of the financial performance of various insurance brokerages across the country.

All information was provided to us voluntarily and is held in the strictest confidence. We have only presented data in the aggregate, and in some cases, we have excluded data that we believed could be used to identify participants.

Our survey results are comprised of 111 participants of whom voluntarily provided operating income statements and written survey responses. For our analyses, we also relied on our own proprietary database, which we believe is one of the largest available databases of independent brokerage financial performance information in Canada.

The report also contains a significant amount of editorial opinion based on the collective experience of the Smythe Property & Casualty team, which includes Chartered Professional Accountants (**CPA**), Chartered Business Valuators (**CBV**), M&A Advisors and Tax Specialists.

As always, we would like to extend our gratitude to all those who chose to participate in this survey. It is our goal whenever we set out to create this report to elevate the insights we provide you with and contribute meaningful research to the industry. None of that would be possible without the trust placed in us by brokerage owners across Canada. Thank you to those who took the time and effort to complete our surveys and share with us their financial data.

Sincerely,

Smythe LLP

Formally established in November 2013, the Smythe Property & Casualty Insurance Group provides our clients in the industry with a full range of professional services in areas including accounting, tax, corporate finance, valuation and M&A consulting.

Our team has a broad network within the industry. We frequently speak to niche groups and contribute to both academic and business publications in the insurance space.

About Smythe's P&C Insurance Group

OUR TEAM

Alex Wong – Advisory Partner & Practice Group Leader, CPA, CA CBV

Alex focuses on M&A advisory services with a specialty in P&C brokerages. Over the past five years, he has been involved in over 15 transactions in the P&C industry, with enterprise values ranging from $5 million to $150 million. His expertise focuses on negotiating and executing M&A transactions, financial due diligence, business valuations, financial modelling and succession planning.

Alex is a founding member of Smythe's advisory practice. He has over 15 years of experience in advising private companies on acquisitions, divestitures, valuations, tax and accounting matters.

(604) 694-7574
awong@smythecpa.com

Gagan Ahluwalia – Advisory Partner, CPA, CBV

Gagan provides advisory services to P&C brokerage owners across Canada in the context of succession planning and strategic advisory. His focus is on business valuations, benchmarking and M&A deal execution, including management buyouts. Over the past three years, Gagan has advised on transactions worth over $300 million, including acquisitions, divestitures, and equity and debt financings.

(604) 643-5373
gahluwalia@smythecpa.com

Maggie Puhacz – Tax Partner, CPA, CA

Maggie provides Canadian tax compliance and tax planning services to both private and public companies in a variety of industries. She focuses on personal and corporate tax planning for owner-managed businesses, as well as mergers and acquisition transactions.

(604) 694-7589
mpuhacz@smythecpa.com

Kyle Inman – Assurance Partner, CPA, CA

Kyle provides business advisory, assurance and taxation services mainly to privately owned Canadian businesses. He has over 20 years of experience working with clients across industries, with a specialization in property and casualty insurance brokerages.

(604) 643-1723
kinman@smythecpa.com

Our Past Projects

Here is a snapshot of some projects in the insurance space that Smythe has advised on:

bedrock Insurance Brokers DIVESTITURE	Arrow Insurance Agency Ltd. DIVESTITURE	Emsland Insurance DIVESTITURE	AXIS ACQUISITION ADVISORY	Reider Insurance DIVESTITURE
kinginsurance DIVESTITURE	FX Insurance Brokers DIVESTITURE	Elevate Insurance Brokers DIVESTITURE	DfI Del fisher Insurance DIVESTITURE	Cain Insurance Services Ltd. DIVESTITURE
Waypoint Insurance DIVESTITURE AND TAX	Northern Insurance Brokers / Navacord MANAGEMENT BUYOUT AND TAX ADVISORY	Waypoint Insurance ESOP ADVISORY	Cornerstone Insurance Brokers Ltd MANAGEMENT BUYOUT AND TAX ADVISORY	DMW Insurance Ltd. DIVESTITURE
Lambert Insurance Agencies Ltd. DIVESTITURE	Shephard Ashmore Insurance DIVESTITURE AND TAX	Shuswap Insurance Brokers DIVESTITURE	Riverstone Insurance DIVESTITURE	Wilfred Leong Insurance Agencies DIVESTITURE
AXIS MERGER ANALYSIS AND TAX ADVISORY	Front Row Insurance Brokers Inc. Entertainment Specialists M&A TAX ADVISORY	Union Power Insurance Brokers DIVESTITURE	Navis Marine Insurance Brokers MANAGEMENT BUYOUT AND TAX ADVISORY	knightarcher insurance brokers VALUATION AND DEBT FINANCING

Canadian P&C Insurance Landscape

The property and casualty (P&C) insurance industry plays a critical role in the Canadian economy.

Property insurance provides financial protection in the event of damage to physical property or valuable possessions such as automobiles and buildings. Casualty insurance mainly covers legal liability against individuals and organizations for negligent acts or omissions. Insurance is an effective way of spreading risk by having an entire group share the losses of a small group. These two types of insurance are also known collectively as "general insurance" as they encompass much of what customers demand.

Two key players in the distribution chain of the insurance industry are insurance companies (also known as underwriters or insurers) and brokers.

The insurance company is usually the one who evaluates risks, sets coverages and premium rates, and collects those premiums from customers upfront to insure risk. They then use this pool of funds to pay out claims and for other operating expenses. There is often a gap between when a premium is collected and when a claim needs to be paid out, which creates a capital pool that the companies can then use to invest. Brokers are generally the final link in the chain, acting as an intermediary between the insurance company and the customer (individual or business). Brokerages can represent multiple insurers, offering their customers options for any type of insurance. Insurance agents, on the other hand, only represent a single insurance company. There are also insurance companies that sell and deliver policies directly to policy holders; these are known as direct writers.

Figure 1: Canadian Market Share

CAD (MILLIONS)		DWP	MKT SHARE	"5YR - CAGR PREMIUMS"	"5 YR - GAIN OR LOSS"
Intact Financial	$	14,212	16.9%	10.9%	2.7%
Aviva		6,422	7.6%	4.0%	-1.2%
Desjardins		6,146	7.3%	4.5%	-0.9%
Lloyd's Underwriters		5,414	6.4%	10.2%	0.9%
Security National		4,545	5.4%	7.4%	0.1%
Co-operators		4,408	5.2%	6.0%	-0.3%
Definity		3,606	4.3%	8.0%	0.2%
Wawanesa Mutual		3,190	3.8%	4.4%	-0.5%
Northbridge		2,982	3.5%	11.9%	0.7%
Allstate		2,640	3.1%	9.9%	0.4%
Other		30,529	36.3%	5.9%	-2.0%
Total	**$**	**84,093**	**100.0%**	**7.1%**	

The financial model of the insurance industry allows a customer to pay their premium either directly to the insurance company (known as a direct bill) or to the broker (agency bill).

Brokerages make the majority of their income from premium-based commissions, i.e., a flat percentage of premiums that varies across lines of business and insurers. This commission typically ranges from anywhere between 11% and 25% depending on the type of policy purchased. In the case of an agency bill, the broker will collect the premium and remit it to the insurance company net of the agreed commission. With a direct bill, the insurance company will collect the premium and then pay the broker the commissions earned.

Insurance brokers may also receive contingent profit commission (CPC). A CPC is paid if a broker places profitable business with the insurer. CPC is generally calculated based on the percentage of claims paid to premiums earned (earned loss ratio) along with the volume of business placed with the insurer. The lower the earned loss ratio, the greater the CPC. These payments can therefore vary significantly from year to year.

In 2022, total premiums written in Canada amounted to approximately $84 billion[1], excluding the Insurance Corporation of BC (ICBC) and Manitoba Public Insurance (MPI). This was across approximately 160 different companies, which equates to around 110 different groups, as several of these companies have common ownership.

The direct written premiums of the top ten insurer groups account for approximately 64% of the market – an increase from the 61% they controlled in 2020. This change, however, is driven primarily by Intact's acquisition of RSA Canada in 2021. After adjusting for the RSA acquisition, the market share for the top ten insurers in 2020 was 65%, meaning that their market share in 2022 dropped marginally.

Despite continued consolidation, the overall market is still competitive. Intact is the only player that controls over 10% of the market. Additionally, aside from that RSA Canada acquisition by Intact, no other insurer increased their market share by more than 1% in the past five years. All insurers saw premium growth over the past five years that was relatively in-line with increases in the overall market (see Figure 1).

1 *All financial metrics regarding insurance companies are from MSA Research*

Insurance companies calculate underwriting profits by subtracting claims and claims-related expenses from premiums. Typically, in a competitive environment, underwriting profit tends to be less than 1% of net premiums, meaning that insurers earn their profits largely through investment portfolios.

The Canadian insurance industry has endured "hard market" conditions for the majority of the past five years, which has allowed insurers to improve underwriting profits by increasing premiums at a faster rate than the rise in claims costs.

An important key performance indicator for insurance companies is the combined ratio, which is the inverse of the underwriting profitability (i.e., claims plus other operating expenses divided by net premiums). Excluding ICBC and MPI, the average combined ratio over the five-year period ending 2022 was approximately 92%. Notably, however, this decreased to 85% in the past two years.

The overall loss ratio for 2022 was approximately 54% and the combined ratio was approximately 85%. As a result, industry profitability in 2022 was seemingly strong, with approximately $9 billion net income and return on equity being around 14%, excluding ICBC and MPI. However, this was in large part due to the release of a significant reserve balances, without which would have resulted in a combined ratio of 96%. In addition, results have benefited from the increase in interest rates, as loss reserves are discounted at higher rates. Excluding these two factors, the industry combined ratio in 2022 was in excess of 100%.[2] The graph below (Figure 2) charts these various profitability measures.

The Canadian P&C insurance market can be broken into four major lines of business: automobile, personal property, commercial property and liability. The split between all of them is shown in this pie chart (Figure 3).

2 *All financial metrics regarding insurance companies are from MSA Research*

Figure 2: P&C Industry Profitability

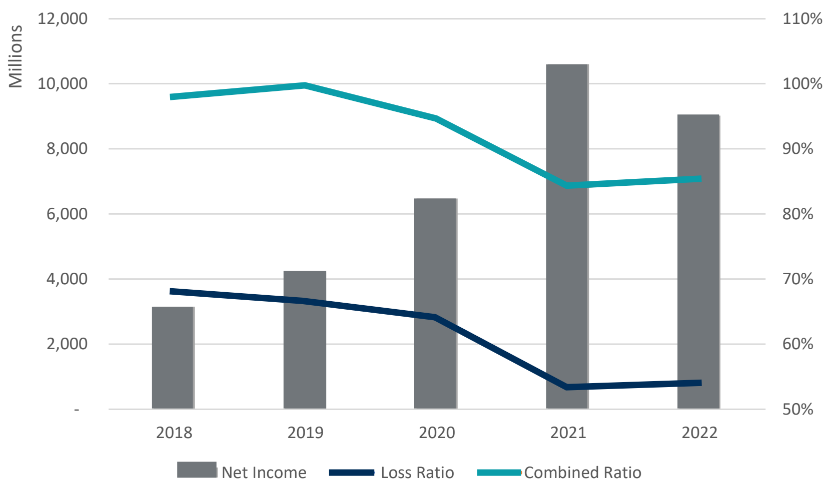
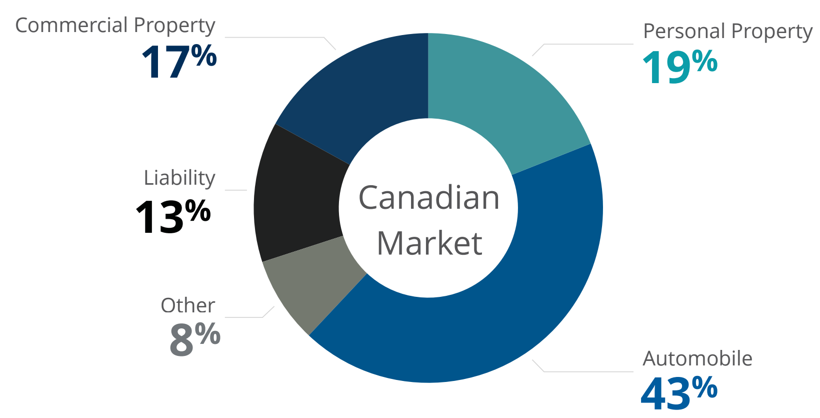


Figure 3: Canadian Market by Line of Business



Using the following rates, we have estimated the commissions paid by insurance companies:

- Automobile: 12%
- MPI & ICBC auto: Based on ICBC & MPI annual reports
- Personal property: 20%
- Commercial property: 20%
- Liability and other: Various

Based on 2022 direct premiums written of $84 billion, we estimate commissions by line of business and province as follows (see Figures 4 + 5 below).

It is important to note that commissions can vary widely depending on the insurance company, use of MGAs, Lloyds, special programs and the negotiating leverage of the brokerage.

That said, however, we found our estimated commissions to be consistent with data available from MSA, which reported a commission expense (excluding ICBC, MPI and CPCs) of approximately $13.9 billion, or 17% of direct written premiums in 2022.

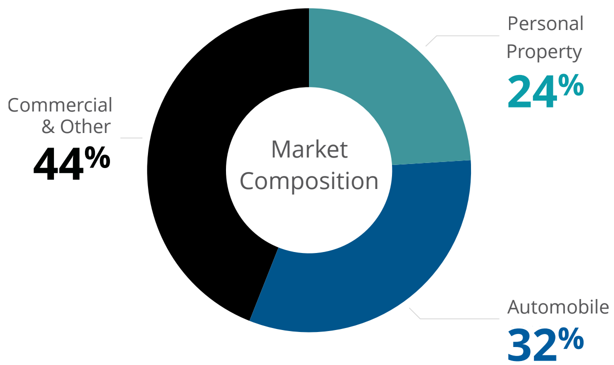
As discussed at the start of this section, CPC revenue is an important component of brokerage profitability. In 2022, insurers reported paying approximately $1.1 billion in CPC. This represents approximately 1.4% of direct written premiums, translating into 8% of total commission income available (excluding ICBC and MPI).

The importance of brokers understanding their CPC agreements cannot be overstated. Those brokers who deliver a large volume of premiums with consistent underwriting results have more leverage in obtaining a favorable CPC arrangement with insurers.

Figure 4: Estimated Market Size by Commission

CAD (MILLIONS) PROVINCE		"AUTO"	ICBC & MPI	PERSONAL PROPERTY	COMMERCIAL PROPERTY	LIABILITY AND OTHER	TOTAL COMMISSIONS	"MARKET SHARE"
Newfoundland and Labrador	$	61	0	53	33	30	177	1%
Prince Edward Island		15	0	10	15	9	50	0%
Nova Scotia		108	0	89	56	66	318	2%
New Brunswick		90	0	66	50	58	264	2%
Quebec		645	0	737	582	577	2,541	18%
Ontario		1,949	0	1,216	809	1,432	5,408	38%
Manitoba		2	95	105	104	87	394	3%
Saskatchewan		150	0	112	130	81	473	3%
Alberta		706	0	518	482	451	2,156	15%
British Columbia		26	691	518	550	535	2,319	16%
Yukon		5	0	4	8	6	23	0%
Northwest Territories		4	0	3	8	8	22	0%
Nunavut		1	0	1	6	2	10	0%
Outside Canada		86	0	14	37	52	190	1%
Total	**$**	**3,848**	**786**	**3,446**	**2,870**	**3,394**	**14,345**	**100%**

Figure 5: Market Composition



Part 1: Our Survey

In our experience, brokerages play a pivotal role in the functioning of the insurance industry, especially when it comes to their interactions with customers.

In most transactions, the broker plays the role of a "market maker". They help the customer identify their coverage needs and then match those needs with insurers that have the capability of meeting those needs at the best value. While it is natural for an insurance company to want to protect their markets, the brokers' mandate is to represent their customers. The integrity of the competitive bidding process is critically important to the health of the marketplace.

Our 2023 survey was conducted in February 2023 and consisted of two parts.

In Part 1 of this report, we will look at the opinions expressed in our survey by insurance brokerage owners and senior executives, and offer our own analysis of what they had to say.

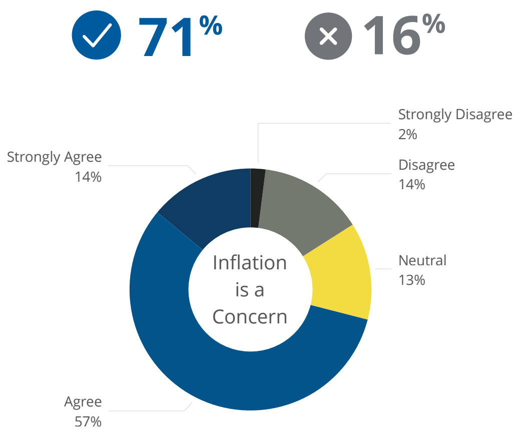


Figure 6

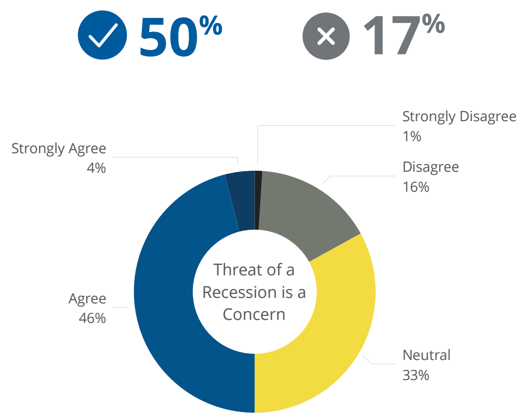


Figure 7

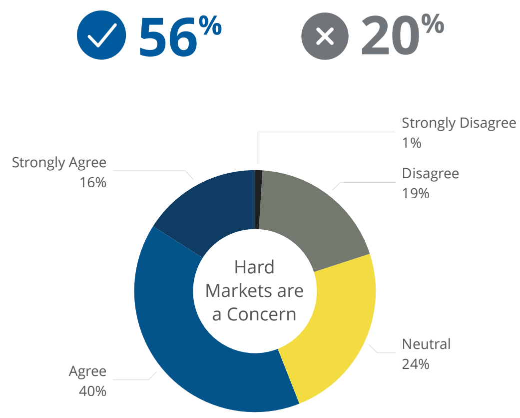


Figure 8

Industry and Economic Trends

Over the last two years, the landscape of the Canadian insurance brokerage industry has continued to see dramatic shifts, throwing up some familiar challenges to those operating in this space.

In particular, respondents to our survey cited the looming threat of a recession and high inflation, continuing hard market conditions and constantly shifting regulations as major concerns for them in the short term.

Nearly three in every four respondents (71%) said the **threat of inflation** remains a major concern. Higher costs for businesses, individuals and insurers can push insurance premiums up, meaning that customers may look for alternative and emerging options to offset the cost, adversely impacting the quality of coverage and brokerages' profitability. Related to this, a full half of all respondents to our survey expressed **concern over a possible recession**, though, generally, economists have downgraded their recession expectations since our survey was conducted (see Figures 6 + 7).

The Canadian P&C industry has been experiencing **"hard market" conditions** for several years now and that looks unlikely to change, with 86% of our survey participants saying this is likely to persist. They are, however, split on whether this is would actually be detrimental to the industry, with just over half (57%) agreeing with the statement that hard markets are a concern. These conditions, coupled with inflationary and recession-related concerns, could lead to softening demand, as it becomes more difficult to find affordable insurance options (see Figure 8).

Brokers were less concerned by how **changing regulations** could impact their business, with only half agreeing this is a worry. This bodes well for the industry, as it can be costly and difficult for businesses to respond quickly to regulatory shifts, and can create an additional, unnecessary burden for brokerages already struggling with staffing shortages.

Additional concerns on the mind of some brokerage executives include **competition from direct writers** and a surge in **consolidation in the industry**, with 44% agreeing with the former and 37% with the latter.

Direct writing maintains favor within the P&C industry, with some companies choosing to sell insurance products directly to customers, completely bypassing brokers along the way. This trend has potentially serious implications when it comes suppressing demand for insurance brokerages by eliminating the "middlemen".

Another notable industry trend in recent years has been the propensity towards consolidation, with record-breaking numbers of mergers and acquisitions. On the one hand, some brokerage owners see increased consolidation as an opportunity to expand their customer base, as people look to switch from large consolidators to smaller brokerages for their needs. On the other hand, however, there are owners who are concerned larger brokerages may receive preferential treatment in a hard market environment.

With these challenging circumstances in play, there is little doubt that we will continue to see an evolution in the P&C insurance brokerage industry. It is now more important than ever for brokers to keep an eye on emerging trends and be quick to adapt to them, if they are to remain competitive and provide value to consumers.

Figure 9: Organic Growth Strategies

Growth Outlook

Responses to our survey yielded some interesting insights in regards to growth outlook.

Around 68% of respondents strongly agree or agree that there are significant opportunities for **organic growth** for their brokerage over the next two years, indicating an appreciable degree of confidence in being able to grow without a reliance purely on M&A activity. (see Figure 9)

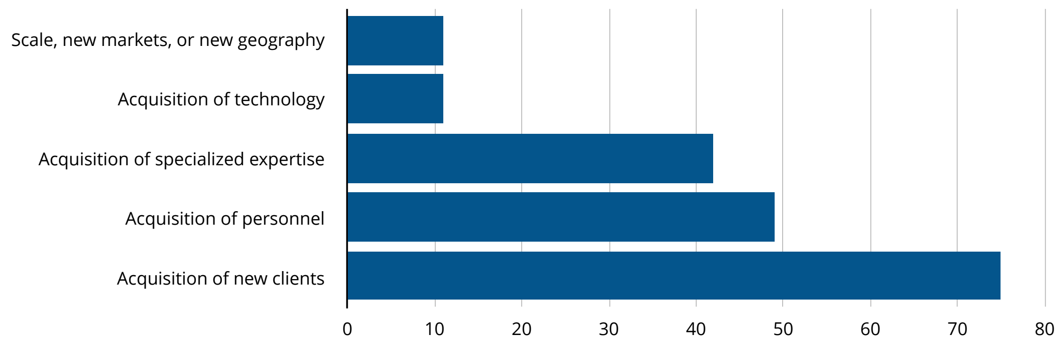
The strategy that led the pack in this aspect was continuing to **mine existing clients** for additional opportunities, with 80% of respondents saying they intend to pursue this route. This method is so appealing because it allows room to increase revenue and profitability by building on existing relationships and expanding the range of services provided, which require relatively lower investment as compared to other options.

Just over half (54%) of respondents said organic growth would be driven by **increasing their online presence** and usage of client-facing technology. This is just a reflection of the growing importance of digital channels for engaging with clients and delivering services more efficiently that experts have noticed in other aspects of the economy.

The third strategy was to invest in and target **specialty lines**, with 53% of respondents indicating their intention to do so. This approach involves developing expertise in specific areas to better serve clients' unique needs and differentiate themselves from competitors. Finally, 50% of respondents planned to **increase the headcount** of their sales team, focusing on expanding their customer base and increasing market share.

On the other hand, 40% of survey participants indicated that M&A is a large part of their growth strategy. Three out of four (76%) of these survey participants cited the desire to **acquire new clients** as the top factor

Figure 10: Reasons for pursuing M&A



motivating plans to acquire another brokerage. Merging with or purchasing another brokerage is a sure-fire way to expand customer bases, gain access to new markets and increase revenue (see Figure 10).

Another attractive feature of M&A is the potential for **acquiring personnel**, according to 49% of respondents. In a tight labor market with stiff competition, acquiring a workforce can help fill any gaps in staff and bring in new talent.

Tangential to this, 42% of survey participants identified the possibility of **acquiring specialized expertise** as a driver of acquisition strategies, as this would likely allow the company to diversify revenue streams by expanding existing capabilities and offering new services.

It is interesting to note, however, that not all the brokerages that responded to our survey view acquisition as a viable option for growth, with 66% actually saying that their organic growth opportunities would be sufficient to meet their objectives. Over half (56%) of the remaining respondents who said they would not pursue an M&A strategy, said this was because deal prices are not affordable to them or that they lacked the internal capacity required to effectively execute an acquisition.

Technology Trends

One of the most impactful lessons learned by businesses during the Covid-19 pandemic was the importance of having a robust digital strategy in place – and the insurance industry is no different.

Features such as online shopping, curbside pickup and food delivery, which were just starting to gain traction before 2020 have now become a ubiquitous part of customers' lives.

Even now, three years after the onset of the pandemic, consumer behavior reflects these preferences. In one recent survey, 57% of customers said they prefer to engage through digital channels and 53% said they prefer to purchase online versus in-person[3]. Specifically in the insurance industry, customers now appear to expect an experience that provides the flexibility to engage with brokerages via multiple channels such as in-person, online or over the phone. As purchasing insurance becomes more convenient, common and –for lack of a better term – commoditized, customer experience and service will become an even larger component of a brokerage's success. And in turn, customers are signaling that digital capabilities are a significant driver of their satisfaction.

Separately from client experience, technology also plays a large role, directly or indirectly, in helping brokerages address the other challenges they face, including in talent acquisition and retention, shifting demographics, climate change and cyber security.

Our survey shows the split in how brokerages manage their IT systems is fairly even. Around 30% of brokerages said they manage their IT function entirely in-house, while 28% said they outsource the function entirely; the remaining respondents said they utilize a mix of both.

In general, in-house IT management can offer greater control and customization but can also be more expensive and can require significant resources. Similarly, while outsourcing IT management can be more cost-effective and can allow for access to specialized expertise, it can also result in reduced control over IT operations.

One interesting point to note is that a sizeable majority of brokerages (63%) expressed concern over the cost of maintaining their current software subscriptions, which is crucial when considering matters of profitability and cash outflow. This may be a necessary trade-off for most, however, given that meeting client satisfaction needs and goals requires some reliance on technology.

In our survey, 69% of brokerages said they intend to increase their use of client-facing technology over the next two years. In addition, 78% said they plan to increase their use of back-office technology. These numbers signify just how large a role technological developments play in determining brokerages' strategic priorities.

Our survey also found that increasing the use of the types of technology that integrate well with insurers' systems is a strong focus for roughly three out of every four brokerages (over 73%).

3 The State of the Connected Customer, Salesforce 2022

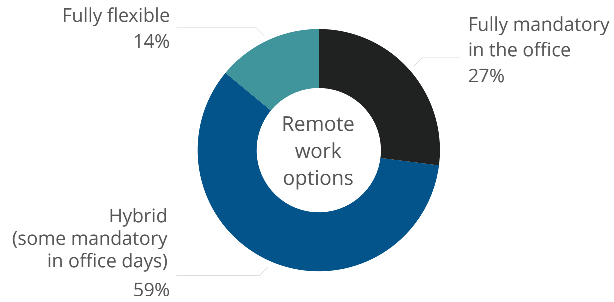


Figure 11

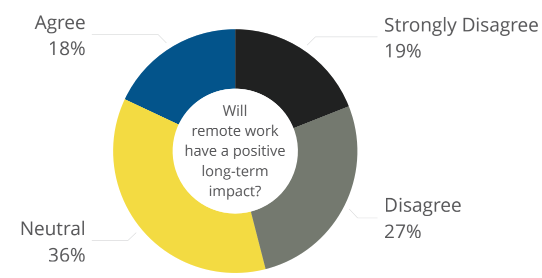


Figure 12

Human Resource Trends

There has been much discussion about the labor market across a range of industries in the last few years, exacerbated by Covid-19 lockdowns and the associated shift in supply and demand dynamics. Like a host of other industries, the Canadian insurance brokerage labor market is also experiencing conditions of a shortage and a so-called "war" for talent. Increasingly, brokerages are having to innovate in terms of what they can offer to distinguish themselves from competition when it comes to attracting and retaining talent.

Only one in three (30%) brokerages who participated in our survey said they plan to increase compensation as a way to attract and retain talent. Financial benchmarking data later in this report will show that brokerages have increased wage expenses significantly over the last two years, and so are now turning to alternative methods to appeal to top talent in the industry.

One strategy that was popular with the respondents to our survey is flexible work arrangements –80% of them indicated that they plan to allow employees to work flexibly, i.e., not requiring in-person office attendance, flexible working hours.

This trend is, of course, in line with the changing expectations of employees themselves, who are seeking greater flexibility in their work arrangements. Catering to this demand, studies have shown, leads to higher productivity and job satisfaction, as well as improved health of employees stemming from a more balanced life. In many cases, there are also cost savings for both the brokerages (in terms of office space requirements and supplies) as well as the employees (in terms of commuting costs). That is not to say, however, that flexible work models don't have challenges. For instance, they require robust communication and collaboration tools, and emphasis must be placed on ensuring data security.

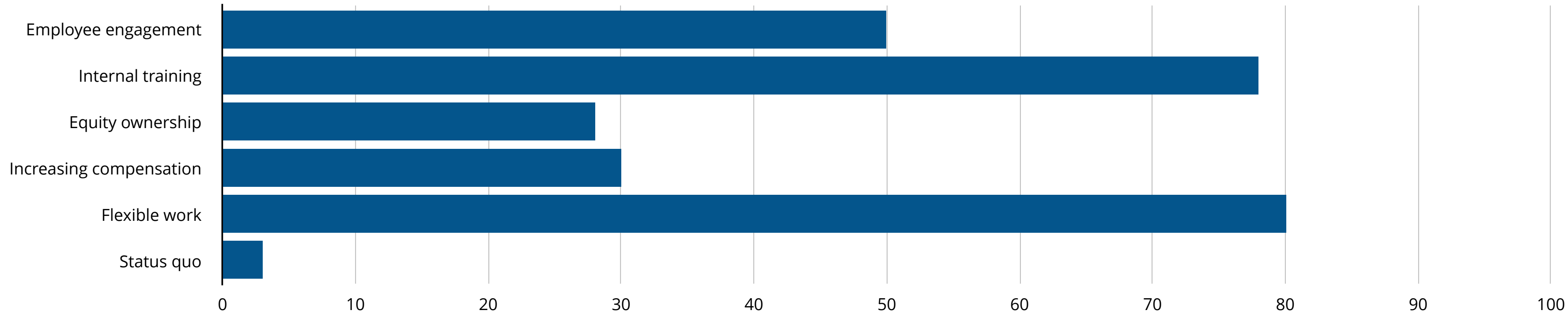
Breaking the survey responses down further, 14% of brokerages said they offer employees full control over whether they want to work remotely or not, while 27% said they are now back in the office full-time.

The majority, however, have adopted a hybrid model, with 59% of respondents saying they required in-office attendance for a part of the week (see Figure 11).

Almost half of all smaller brokerages (i.e., those with fewer than 25 employees) said they are back to office full-time, a strong indication that the size of the firm does impact where it falls on the spectrum between fully remote and fully in-office. This could be because of the cost-prohibitive nature of implementing the security, communications and technological infrastructure required to maintain workforce cohesion at that size.

On the other hand, even though most of the respondents said they had embraced flexible work arrangements as a strategy, they were not certain it was a positive trend. Only 19% of respondents said working from home would have a positive impact on the business, with a full 46% saying it would have a negative impact (see Figure 12).

Figure 13: Personnel strategies



Moving onto other talent retention and attraction strategies, our survey also found that 79% of brokerages plan to enhance their internal training, mentoring and coaching programs to help employees improve their skills and knowledge, so they can serve clients better. An additional benefit of this is that training programs have been found to help create a strong internal talent pipeline, reducing voluntary turnover and enabling more promotions from within the company.

Another popular strategy was introducing or enhancing employee engagement programs such as social activities, team-building events and retreats, which help improve morale and job satisfaction.

Around 50% of brokerages said they were planning to implement this strategy to foster a greater sense of community and belonging among their workforces.

Finally, a not-insignificant number brokerages said they are considering offering equity ownership to their employees. Around 29% of all survey respondents, including 21% of closely held family-owned brokerages, said they are considering providing some form of equity compensation to employees. While the majority of brokerages still prefer a traditional ownership structure, we have seen many brokerages successfully implement an employee-ownership program to motivate employees, improve retention and align interests (see Figure 13).

Leaving aside personnel-related strategies, another way businesses try to fill gaps in their workforce is by outsourcing certain functions. While this might be more popular in other industries, our survey shows limited appetite among brokerages for outsourcing labor needs – only 20% of brokerages are already using or considering outsourcing as a viable option over the next two years, with 54% disagreeing this is the case.

Part 2: How Brokerages are Planning for the Future

As one of the premier property and casualty insurance brokerage advisors in Canada, Smythe often receives questions about succession planning.

Through these advisory services and the biennial survey, we have been discussing in this report, we have developed a unique insight into what brokerage owners are thinking about when it comes to planning for the future of their business.

Within the P&C insurance industry, the most popular succession plans remain:

- Merging with another brokerage
- Passing the business on to family members
- Sharing ownership with employees

There is an old saying among gardeners that the best time to plant a tree was 20 years ago, but the second-best time is now. In our experience working with companies of all sizes, across all industries and with all types of organizational structures, the earlier a brokerage owner starts planning for the future, the better. The further in advance you know what strategy you will follow, the better you can plan.

As you evaluate the options discussed in this section, here are some basic steps you can take:

1. Assess your business. This includes reviewing your financial statements, client base and business operations, and identifying and acting on any areas where your business could use improvement or where you see room for growth.
2. Get your financial systems and processes in order. In a data-driven world, it is critical to have processes and systems in place to ensure timely, up-to-date and accurate financial information on your books and financial statements to manage your business, plan for growth or to withstand scrutiny if undergoing a divestiture.
3. Focus on growth and profitability. You should identify areas for growth (e.g., cross-selling opportunities, segmentation or affiliate arrangements) and review any inefficiencies in your brokerage and look for ways to improve them. This could include automating certain tasks, reducing overheads or outsourcing certain functions.
4. Build a strong team. You should invest in building an effective leadership team at your brokerage that can effectively manage operations in your absence. This will protect your business value should you be unable to work for unforeseen reasons, and will also make your brokerage a more attractive turn-key acquisition target.
5. Seek professional help. You may want to build a team of professional advisors well in advance of moving forward with any succession plan to help ensure everything goes smoothly (e.g., lawyer, tax advisor, accountant, M&A advisor, wealth management professional, etc.). This will put you in the best position to navigate a complex transaction process while also managing day-to-day business, maximizing value, minimizing tax burdens, protecting your legal interests and helping manage your finances as you suddenly come into cash.

In the rest of this section, we will examine some current valuation and M&A trends and issues around each of the options brokerages have in terms of succession planning.

Brokerage Valuations

In general, the insurance brokerage industry has seen a significant shift in the way valuations are calculated. While revenue multiples were the norm in the past, valuations based on EBITDA have become more prevalent as the industry has evolved. This shift in methodology has been driven by a variety of factors, including the growing importance of underlying profitability and cash flow.

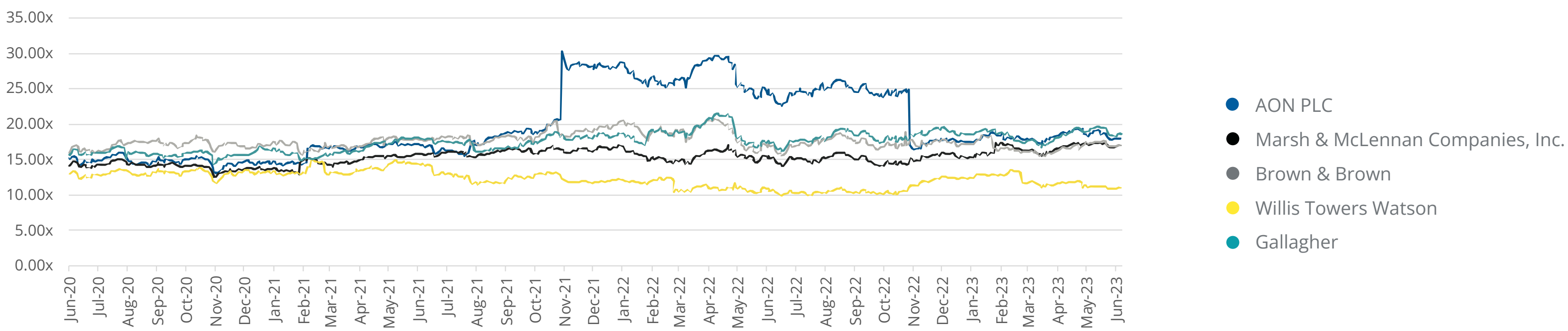
One trend that has emerged in the valuation of brokerages is the high demand for brokerages with a specialization, or those that have demonstrated success in penetrating a high-quality segment of the market. These brokerages have carved out a niche for themselves, which results in either limited competition or in a proven ability to capitalize on affinity relationships of their targeted segments. Program business would fall into this category, for instance, and in recent transactions Smythe has been a part of, they have attracted premium valuation multiples.

Size also matters in the valuation of brokerages, with larger brokerages commanding higher pricing due to their scarcity, immediate scale and turn-key operations. With that being said, we are still observing higher multiples regardless of size if the target brokerage complements an acquirer's existing business or provides a strategic advantage in terms of specialization, expertise or entry into a new geography. In fact, we have observed pricing upwards of 14-15 times EBITDA for larger specialized brokerages.

Going off the old adage that a rising tide lifts all boats, smaller to medium-sized brokerages are still being valued at high multiples, though they typically generate fewer offers at a high multiple, given that the number of purchasers focusing on the smaller end of the market has shrunk.

Consolidators, in particular, are able to justify higher pricing due to their scale and their ability to achieve both back-office and revenue synergies. Back-office synergies include cost savings through the consolidation of administrative functions such as accounting, human resources and IT. Revenue synergies are achieved through commission overrides at the carrier level and other cross-selling opportunities. Consolidators are typically able

Figure 14: EV/EBITDA Multiple



to quantify these synergies to a known degree of certainty, which allows them to price aggressively.

Interest rate hikes since the beginning of 2022 in both Canada and the US have, obviously, tightened debt lending appetite across the board, which emphatically marks the end of a period of cheap money that lasted well over a decade. Despite this shift in market conditions, M&A activity in the P&C insurance sector remains strong. We have noted, however, heightened purchaser focus on the underlying profitability and cash flow of a brokerage, which has led to more valuations based on EBITDA rather than revenue.

By using EBITDA as a valuation metric, investors can better understand the cash flow generated by the business, which is a critical factor in assessing what the company is worth. We find, however, that revenue multiples are still relevant in certain cases such as where a brokerage's profitability is lower than average or where a brokerage is small enough that a purchaser can easily influence the existing cost structure. In these cases, revenue multiples may provide a more balanced reflection of the brokerage's value.

Over the past few years, earnouts were less commonly used in bridging valuation gaps between buyers and sellers. We instead observed the incorporation of earnouts more as a "premium" component of a brokerage's value, based on achieving growth over and above a minimum hurdle rate of growth. In other words, sellers have been getting full value for their brokerage on closing, plus a bonus payment as a sweetener. We expect earnouts to continue to be used in this fashion for large and specialized brokerages, and eventually to become a common method to bridge valuation gaps between buyers and sellers once again.

Figure 14 above illustrates the valuation multiples for publicly traded brokerages over the past three years. During 2021 and 2022, certain brokerages were valued in excess of 17 times EBITDA. In general, publicly traded companies are valued higher than their privately held counterparts due to matters of liquidity, scale and corporate governance. While large privately held insurance brokerages would command premium multiples, our view is that the valuation of a high-performing publicly traded brokerage would be an indicator of the ceiling for a value of a privately held equivalent. For small and medium-sized brokerages, a valuation multiple of less than what an acquirer would sell for would be accretive to the purchaser through arbitrage, but we have observed a further reduction in consolidator interest for small opportunities.

Mergers and Acquisitions

Despite economic uncertainty and the increasing cost of debt, M&A activity in the P&C industry has continued at a rapid pace over the last few years, mainly driven by large consolidators competing for market share.

Between 2018 and 2021, the number of publicly announced brokerage transactions slightly increased year over year from 37 transactions in 2018 to 55 in 2021. However, 2022 saw a significant increase to 65 transactions. As of May 2023, there have already been 23 publicly announced acquisitions.

Our view is that this notable surge in acquisition activity is due largely to the low cost of debt over the past four years coupled with a robust pool of investor capital that is looking achieve a healthy rate of return in a period of heightened uncertainty. The data seems to offer clear proof, once more, that the Canadian P&C insurance industry is highly resilient and is a reliable safe haven for investment returns.

Acquisitions by private equity-backed consolidators (PE) rose from approximately 37% before the onset of the COVID-19 pandemic to accounting for over 65% of all transactions in 2020 and 2021. However, 2022 saw insurers or insurer-backed brokerage acquisitions surging to nearly 40%, up from the 11% in 2020.

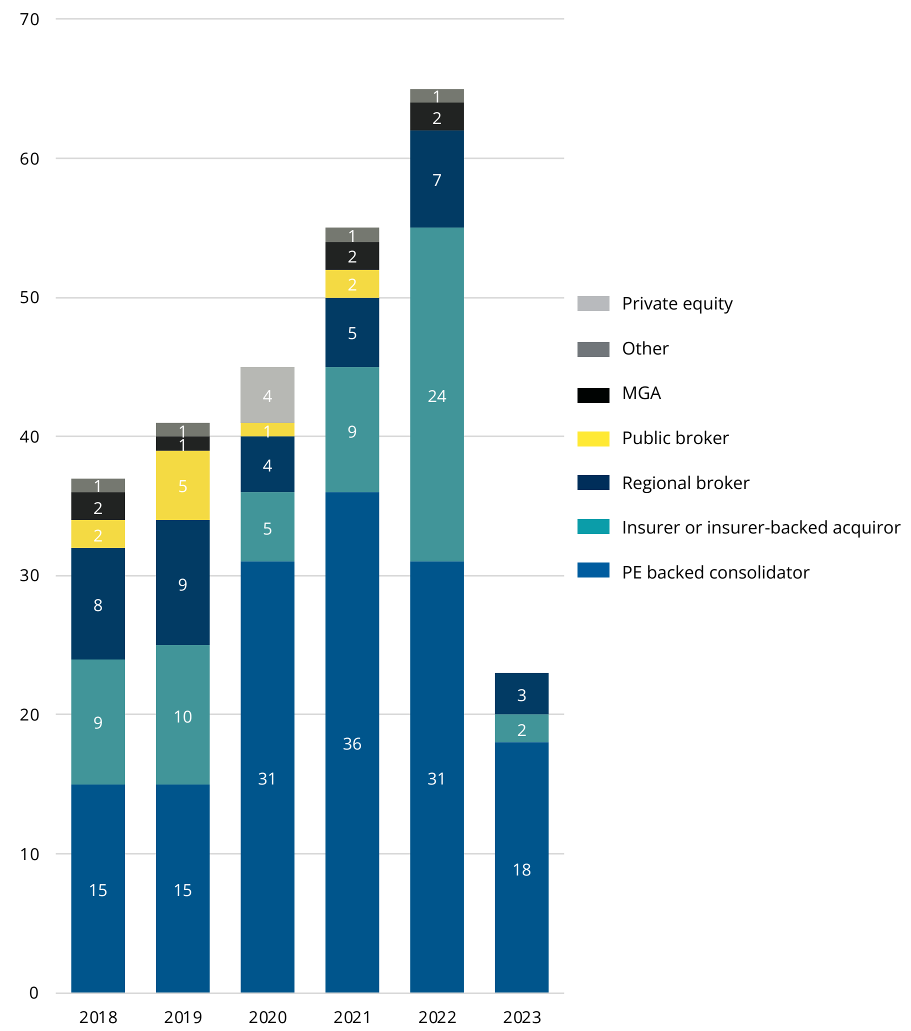
It is important to note that the figure representing transactions completed by independent brokerages might be distorted, as not all transactions are reported. The majority of publicly reported transactions are made by national consolidators. Transactions between local and regional brokerages often go unannounced.

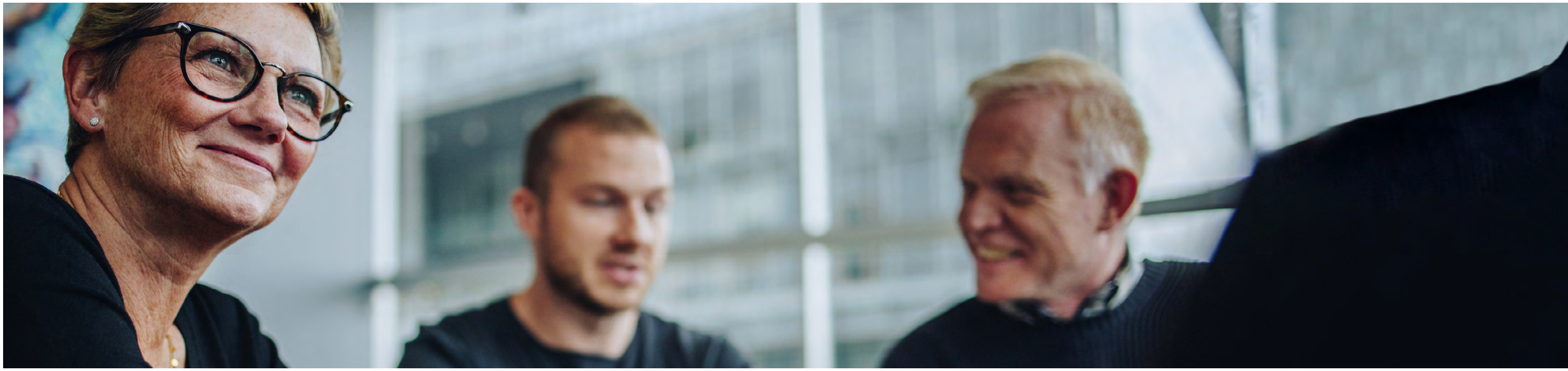
In our observations, regional brokerages are either not willing to or are not able to compete on pricing with the national consolidators. Instead, they cater to a segment of brokerage owners that would rather transition their business to an acquirer with a similar cultural fit or set of values. This includes smaller independent brokerage owners that merge with each other in order to increase scale, consolidate resources and alleviate the pressures of being a smaller brokerage in a consolidating industry (see Figure 15).

With over 23 brokerage transactions already announced in the first five months of 2023, our view is that M&A activity will remain resilient for the foreseeable future. We believe that a number of factors will shift market dynamics in regards to valuations and/or terms, including concerns over the rate of inflation, the "war for talent" and market sentiment indicating a recession resulting in economic tightening and a higher cost of debt. As there are still record highs of dry powder, acquirers relying on debt facilities to fund acquisitions will likely be more selective with their acquisition targets.

When it comes to acquirer focus, we have observed a diversification from traditional P&C brokerages into other verticals such as group benefits and wealth management, with several such transactions having occurred in recent years. We believe this is mainly due to companies' growth objectives and their desire to increase a customer's wallet share by cross-selling products to create a moat around the customer relationship. As a result, we anticipate more M&A activity in other verticals and other parts of the value chain going forward, especially as the number of property and casualty brokerages available for sale shrinks.

Figure 15: Completed Transactions by Acquirer-type





Transferring Your Brokerage to Family Members

For many family-owned brokerages, the ideal succession planning option is to pass ownership to the next generation. If you have family members in the next generation who are active in the business and have effective leadership skills or demonstrate potential as a brokerage owner, your preference may be passing ownership to them instead of selling or merging with another firm.

The biggest advantage with this option is that it can keep the business you invested so much effort into within the family and can ensure that it continues to operate according to your vision and values. On the other hand, these transitions can often be more complex than a straightforward merger or sale, as the next generation of your family likely does not have equity to invest into the brokerage. As a result, the family has to be more thoughtful about how to finance such a transition. Secondly, there are many tax implications associated with transitioning ownership of a brokerage to a family member.

In general, the cash you will receive as the exiting shareholder will be a combination of these two forms:

1. Initial payment based on the amount that the next generation can finance
2. Future payments based on cash flow that be taken out of future earnings

Many lenders have programs to finance the buyout of brokerages; however, given current valuations, the amount that can be financed is usually less than half of the total brokerage value. Even if you are willing to provide a family discount, it is likely that you won't receive the full amount of your proceeds on closing. In the majority of family transfers, the remainder of the proceeds are paid out over a number of years based on the excess cash flow from the business.

Once you determine the amount to be paid, there are various ways that these payments can be structured. Tax planning is usually the most significant consideration when determining the preferred payment structure. Here are some general tax factors you will want to consider when planning for the transfer of your brokerage to the next generation:

- selling assets versus shares (or a hybrid of both)
- attribution rules
- deemed disposition rules
- differences between business income, capital gain and dividend tax rates
- tax deferral opportunities
- loss planning
- the lifetime capital gains exemption

In our experience dealing with family transfers of brokerages, we have observed that utilizing a family trust or estate freeze can be an effective way to transfer ownership to the next generation while still retaining control that can be passed on at any time. Historically, this has been the most common structure for the transition of a family-owned brokerage. Such a plan generally minimizes tax liabilities and preserves wealth while also handing over the business. Establishing a family trust involves freezing the current value of the brokerage and introducing a discretionary family trust that will own the growth shares of the business. The current owner(s) of the family brokerage would be trustee(s) and would control the business as they had before, while the trust would have beneficiaries that may or may not be involved in the brokerage.

Going down this path has a number of benefits such as multiplying the lifetime capital gains exemption among family members; distributing shares held by the trust among family members that are part of the brokerage succession and beginning estate planning for the current owner(s). This structure can be put into place several years in advance of the intended transition date.

The introduction of Bill C-208 in 2021 added an additional option for brokerage owners looking to pass their business to the next generation.

Initially proposed as an easier way to facilitate intergenerational transfers of small businesses, Bill C-208 was an important change hailed by many as it equalized the income tax treatment between an arm’s-length party sale and a sale to the next generation. Before the change, the sale of shares to an arm’s-length party were taxed as capital gains whereas the sale of shares to children were taxed as dividends.

Since the release of the bill, however, the federal Department of Finance expressed significant concerns over how few restrictions the rules had and potential abuse of loopholes. As a result, the Federal Budget delivered on March 28, 2023 made changes to Bill C-208 to add additional criteria for which transactions would qualify for capital gains treatment. The revisions to the bill allow for the immediate or gradual intergenerational transfers of Qualified Small Business Corporation shares to qualify if certain criteria are met.

Of course, as these rules are very new and the tax landscape is constantly evolving, we recommend always consulting an experienced tax professional when considering transferring ownership of a business to family members to ensure all tax implications, as well as new legislation, are addressed.

Sharing Ownership with Employees

The idea of sharing ownership of a brokerage with employees is one that has gained traction recently, with the federal government even announcing a new type of trust in 2023 to support employee ownership.

Such plans are often very effective in incentivizing and retaining key employees while also ensuring that the business continues to operate in a manner consistent with the original owner's values and vision. Allowing vital employees to have a stake in the business allows for greater alignment in interests and can have a significant impact on productivity. These advantages can prove to be an invaluable differentiator from competitors in tight labor markets.

Traditionally, owners interested in this avenue have opted to set up an Employee Stock Option Plan (ESOP), which allows select employees to gradually acquire ownership over time. These compensation plans offer a certain number of shares of brokerage at a set price, called the "exercise price". The exercise price can be set at the current market price of the share at the time the option is granted but may also be set lower to provide an additional incentive for employees. The stock options typically have a vesting period, during which the employee must continue to work for the brokerage to be eligible to exercise the option.

ESOPs are attractive to employees as they are allowed to defer related taxes on the stock options until they are exercised or even until they are sold in many cases. Further, in some circumstances, employees can be taxed on any related stock option benefits at 50% the rate of their salary.

Setting up an ESOP is complex and requires collaboration with legal, tax and accounting experts to be successfully executed. They need to be designed, planned and managed to be cost effective and equitable.

Another more recent option, as mentioned previously, is setting up an Employee Ownership Trust (EOT). Initially introduced in the 2023 Federal Budget delivered on March 28, 2023, EOTs would serve as a succession plan to allow employees of a privately held corporation to access the corporation's shares without directly paying for those shares.

The proposed legislation notes that a qualifying EOT must meet certain conditions, including:

1. The Trust is a Canadian resident that holds shares of a qualifying business for the benefit of employees who are beneficiaries.
2. The distributions to the employees must be formula based.
3. At least 90% of the business' assets must be used in an active business in Canada and the business is not carried out as a partner of a partnership.
4. The Trust must control the qualifying business.
5. At least 90% of the Trust's assets are shares of qualifying businesses.
6. The trustees of the Trust must be elected by the beneficiaries and the existing business owner must be limited as a trustee.
7. The Trust cannot allocate shares of a qualifying business to any employee beneficiary.

This type of trust is still new, and the details are being worked out, so while some aspects make it a viable alternative option for family brokerages, an ESOP or transferring of ownership to a family member may be more feasible. To pick the best fit of available options when it comes to succession planning, it is imperative to consult with experienced tax professionals.

Part 3: Financial Benchmarking Data

Our methodology for this analysis of the Canadian P&C insurance brokerage market involved us soliciting brokerages to provide internal operating income statements and to participate in an executive survey. In addition, we used data from our proprietary database.

We received financial information from brokerages with revenues ranging from $240,000 to over $400 million. The financial data for each participant included results for the latest 12-month period made available.

Our objective is to present the data in this report in a clear and unbiased manner. We adjusted the data provided to make it as comparable as possible. Some of the adjustments include:

- EBITDA was considered the best measure of operational performance and we added back interest, amortization, and income taxes
- Where possible, we normalized expenses to exclude non-market expenses and compensation
- We reclassified certain expenses for sample consistency purposes. Having said that, inconsistent expense allocation is a limitation when comparing and aggregating data from different companies

Our analysis of aggregated brokerage results reveals some interesting trends that reflect the current state of the market. With a total revenue of over $1.1 billion from brokerages with branches in rural communities and major cities across Canada, we believe our report provides a valid representation of the overall Canadian market for privately owned insurance brokerages. However, there appears to be increased participation from commercial lines focused brokerages, which we'll describe further in our sales mix.

One of the most significant findings from our report is that the overall operating profit margins averaged 28%, marking a 4% decrease from our 2021 report and a return to pre-pandemic performance. We believe the decrease in profitability is due to inflation and the rapid increase in wages, which coincides with personnel expenses as a percentage of revenues increasing from 50% in 2021 to 55%. This is an important observation that suggests that insurance brokerages are facing higher costs to maintain their operations, which is putting a strain on their profitability.

Another trend that emerged from our report is that contingent profit commission (CPC) comprised 9% of total revenue, which approximates the 8% implied by MSA and is a significant increase from the 6% from our 2021 study. This is primarily due to the COVID-19 shutdown resulting in fewer claims in 2020 and 2021, coupled with rising premiums. However, as the economy continues to recover and businesses resume normal operations, we expect CPC may return to historic levels.

Sales Mix

CPC income represented 9% of overall revenue, which is approximately 28% higher than the reported results in our 2019 and 2021 studies. As there are no expenses associated with CPC, it is an important component of brokerage profitability. If we were to normalize this to historical levels of approximately 7%, overall average operating profit margin would fall to 26% in this year's study. This suggests that it is important for brokerages to maintain a profitable book of business to sustain their overall profitability.

We observed that the proportion of auto commission has significantly decreased, which we attribute to the increased participation of large commercial lines focused brokerages, and an overall decrease in auto premiums resulting from the pandemic. This highlights the importance of diversifying product offerings to maintain a balanced sales mix.

For the first time, some brokerages have started reporting their group benefits and life revenues as a separate revenue stream, which is consistent with our observation of increased acquisitions in this space in recent years. This suggests a growing trend towards cross-selling initiatives amongst brokerages to increase their offering to cover a wider range of risks and needs.

Regardless of the sales mix, with the significant impact of CPC on the bottom line, maintaining a profitable book of business will be an important component of a brokerage's profitability in this period of inflation (see Figure 16).

Figure 16: Revenue Comparison

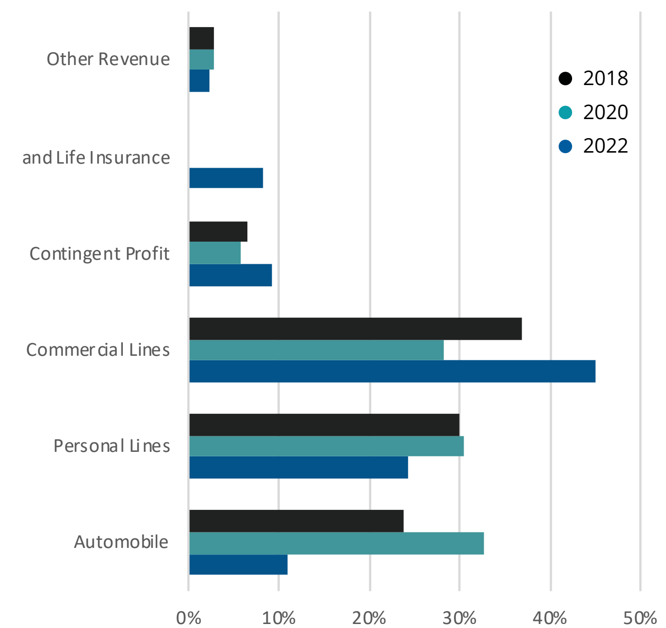
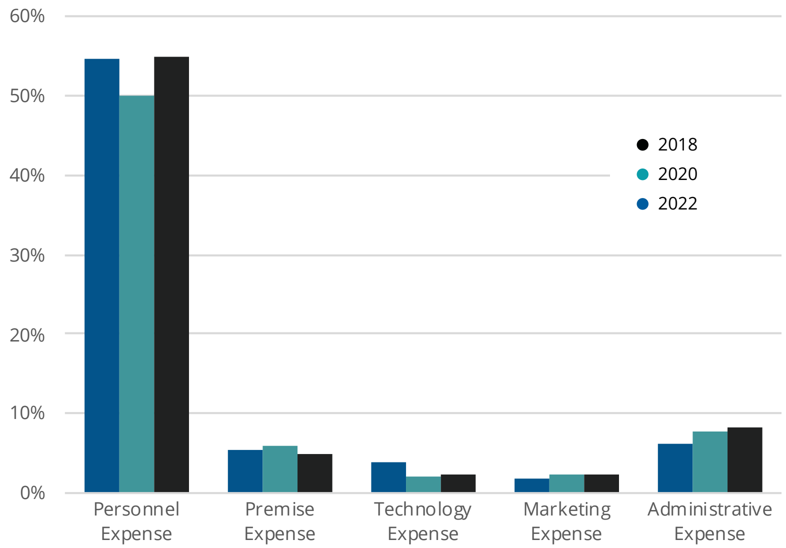


Figure 17: Total Expense Mix



Expense Breakdown

Based on our analysis of aggregated results we have observed several expense trends. We categorized expenses into five main categories: personnel, premises, marketing, administration and technology.

P&C insurance brokerages have relatively stable and predictable operating metrics. However, we noted two observations:

1. The larger expense categories increased as a percentage of revenue compared to the last edition of our study.
2. Expense categories as a percentage of revenue have mostly returned to pre-pandemic levels, suggesting that results during the pandemic were more of an anomaly than a shift in profitability.

This increase was particularly noticeable in personnel and technology expenses. Note that several brokerages did not separately break out technology expense which are likely grouped with administrative expenses, meaning that although technology expense as a percentage of revenue from our survey have increased over our previous study's results, it is still likely understated.

The increase in labour costs as a percentage of revenue can be attributed to inflation and the war for talent, which outpaced any premium rate increases since our last study. This suggests that insurance brokerages are struggling to keep up with rising labour costs. Responses to our Executive Outlook survey indicated that following the significant increases in wages over the past two years, brokerages plan to improve the employee experience rather than competing over compensation to impact employee retention.

With the growing focus on technology, we're not surprised to see an increase in technology expenses in the last two years. Insurance brokerages are investing more in technology to improve efficiency and stay competitive in the market.

Marketing expenses have continued to decrease, and our view is that this shift is due to a growing focus on selling online and virtually (see Figure 17).

Top Performers

According to our study, the top performing brokerages achieved operating margins that were 15% better than the remaining sample, which is up from the 12% gap from the last edition of our study. This marks a return to pre-pandemic performance gaps between top performers and the remaining sample, which suggests that 2020-2021 had a more sizeable temporary impact on a segment of brokerages compared to their higher performing peers.

These top performers spanned specialty commercial insurance brokerages, general insurance brokerages with program business or successful segmentation strategies to large scale regional brokerages. The main reason for their improved profitability was significantly lower personnel costs as a percentage of revenue, although it's worth noting that in some cases due to their scale, these brokerages had lower expenses in other areas as a percentage of revenue compared to the remaining sample.

Consistent with previous results, the sales mix of the top performers were heavily weighted towards commercial lines, however we note that CPC for both top performers and the remaining sample were 9% of overall revenue, compared to 6% in our previous study. This indicates that the seemingly elevated CPC is potentially masking a general decline in brokerage profitability for both top performers and the remaining sample (see Figure 18).

Figure 18: Aggregate Results - Top 20% Of Brokerages Operating Profit Margin

	TOP PERFORMING 20% SIZE %	REMAINING SAMPLE SIZE %
Automobile	11%	11%
Personal Lines	17%	25%
Commercial Lines	60%	44%
Contingent Profit	9%	9%
Group Benefit and Life Insurance	0%	9%
Other Revenue	2%	2%
Total Income	**100%**	**100%**
Total Personnel Expense	42%	56%
Total Premise Expense	3%	6%
Total Technology Expense	3%	4%
Total Marketing Expense	3%	2%
Total Administrative Expense	7%	6%
Total Expense	**58%**	**73%**
Operating Income	**42%**	**27%**

Commercial-focused brokerages

Commercial lines focused brokerages typically have lower volume, but larger premium policies relative to personal lines focused brokerages. In addition, they typically have a lower headcount, and more employees that are compensated on a commission basis. In the table below, we've separated the results of brokerages with revenues weighted > 50% in commercial lines and those with <50% in commercial lines (see Figure 19).

Based on these results, commercial lines focused brokerages remain more profitable at a 31% margin compared to their counterparts (25%). Much of the difference is due to personnel expenses; however, there are significant improvements in other line items such as premises expenses. Although the per/employee compensation might be higher than personal lines, the relatively lower headcount results in significantly lower compensation overall. Further, with a lower headcount, the amount of in-office space and other overhead costs results in material cost savings. Commercial-focused brokerages also have fewer locations since they don't generally require retail storefronts. Additionally, with the multi-year hard market, revenues have increased significantly, which allows a brokerage to realize economies of scale over fixed costs without materially increasing client or policy count.

Figure 19: Aggregate Income and Expenses of Brokerages by Commercial segment >50%

	COMMERCIAL >50% SIZE %	COMMERCIAL <50% SIZE %
Automobile	5%	18%
Personal Lines	15%	36%
Commercial Lines	58%	29%
Contingent Profit	10%	8%
Group Benefit and Life Insurance	11%	5%
Other Revenue	2%	3%
Total Income	**100%**	**100%**
Total Personnel Expense	53%	57%
Total Premise Expense	3%	8%
Total Technology Expense	4%	4%
Total Marketing Expense	2%	1%
Total Administrative Expense	6%	6%
Total Expense	**69%**	**75%**
Operating Income	**31%**	**25%**

Results based on size

The table below groups brokerage results based on size, with the smallest group being brokerages with less than $2 million in revenue and the largest group having revenues in excess of $100 million in revenue. Historically, smaller brokerages typically achieved higher profit margins relative to mid-sized brokerages due to being directly managed by the owner and being in smaller communities with relatively lower cost structures. However, in this year's study, we observed increasing profitability with increased scale. Our view is that the ability to achieve higher CPC and/or higher commission rates provides more return on the investment in infrastructure and personnel. Further, investments in infrastructure are scalable, meaning that profitability increases as the brokerage continues to grow (see Figure 20).

Figure 20: Profitability by Brokerage Size

	SMALL < $2 MILLION SIZE %	MEDIUM $2 TO 10 MILLION SIZE %	LARGE $10 TO 100 MILLION SIZE %	NATIONAL > $100 MILLION SIZE %
Automobile	25%	22%	13%	8%
Personal Lines	30%	31%	23%	23%
Commercial Lines	41%	39%	54%	44%
Contingent Profit	3%	5%	9%	10%
Group Benefit and Life Insurance	0%	0%	0%	12%
Other Revenue	1%	2%	2%	3%
Total Income	**100%**	**100%**	**100%**	**100%**
Total Personnel Expense	56%	55%	53%	55%
Total Premise Expense	6%	5%	5%	5%
Total Technology Expense	2%	3%	4%	4%
Total Marketing Expense	1%	3%	2%	2%
Total Administrative Expense	10%	9%	6%	5%
Total Expenses	**76%**	**75%**	**71%**	**71%**
Operating Income	**24%**	**25%**	**29%**	**29%**

APPENDIX:
Aggregate Income and Expenses of Brokerages in 2022, 2020 and 2018

CAD	2022	2020	2018
Automobile	10.9%	32.7%	23.8%
Personal Lines	24.3%	30.4%	29.9%
Commercial Lines	45.0%	28.3%	36.9%
Contingent Profit	9.2%	5.8%	6.5%
Group Benefit and Life Insurance	8.1%	0.0%	0.0%
Other Revenue	2.4%	2.7%	2.9%
Total Revenue	**100%**	**100%**	**100%**
Operating expenses			
Salaries, wages and benefits	44.8%	42.8%	43.6%
Commissions	9.5%	7.0%	11.2%
Recruitment and Training	0.4%	0.2%	0.1%
Personnel expense	**54.7%**	**50.0%**	**54.9%**
Premise expense	**5.4%**	**5.9%**	**5.0%**
Technology expense	**4.0%**	**2.1%**	**2.4%**
Marketing expense	**1.7%**	**2.2%**	**2.5%**
Administrative expense	**6.1%**	**7.7%**	**8.3%**
	71.9%	**67.8%**	**73.1%**
Operating income	**28.1%**	**32.2%**	**26.9%**

Smythe LLP

1700 – 475 Howe St.
Vancouver, BC V6C 2B3

T: 604 694 7500
F: 604 688 4675

smythecpa.com