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What's a Brokerage Worth?

A Look at E.W. Blanch

In 1993, Schiff's *turned its attention to reinsurance broker E.W. Blanch, which had just completed an IPO at $18.50 per share. Then, as now, we were of the old school, and had quaint ideas about how insurance brokers should be valued. By our reckoning they were worth about one to one-and-a-half times revenues—maybe more if the business was especially good.*

From our vantage point, there are several obvious risks to an insurance or reinsurance brokerage: 1) The assets—employees—leave the premises at the end of the day; 2) Most brokerages have little in the way of tangible net worth; 3) Extraordinarily high profit margins aren't usually sustainable; and 4) Brokers with extraordinarily high profit margins are rarely able to grow rapidly and still maintain high margins.

In light of Blanch's recent problems—which include the loss of key employees, a stock that has collapsed from $71.75 in July 1999 to $8 now, and a bad habit known as "losing money"—we're reprinting the article we wrote in 1993, (when Schiff's *had few subscribers).*

At the end of the article we've added some new thoughts, and compiled a table of relevant statistics.

How much is a reinsurance broker worth? More specifically, how much is a reinsurance broker with $54.6 million in revenues and $9.2 million in after-tax income worth?

If you guessed $250 million, you would have been correct—at least on May 6, 1993—the day E.W. Blanch Holdings went public. On that day, insiders availed themselves of the bull market in insurance and reinsurance stocks and unloaded $49.3 million of their own shares, which, apparently, were scooped up by investors who weren't put off by Blanch's negligible net worth and price-earnings ratio of 23.

Minneapolis-based Blanch is one of the leading reinsurance brokers in the United States (it handled $1.4 billion of ceded premium last year) and its clients, which number more than 300, tend to be specialty or regional companies with less than $50 million in surplus. As a result of their relatively smaller size, Blanch's clients—unlike the largest insurance companies—are generally not discretionary buyers of reinsurance. They pretty much *have* to buy it—a plus for Blanch.

Blanch is a good place to work. Nineteen of the company's 329 employees own stock worth more than $2 million, 11 own stock worth more than $1 million, and 11 more own stock worth more than $440,000. But is Blanch a good place for a non-employee to invest his money?

Samuel Liss and Mary Rhei of Salomon Brothers, which underwrote Blanch's public offering, are recommending the stock and projecting that earnings per share will grow 20% in 1993. That will be even more impressive than it sounds because 15% of 1992's earnings (about $2.2 million) came from reinstatements of catastrophe coverages related to Hurricane Andrew.

Liss and Rhei are also projecting a 30% earnings' increase in 1994, to $1.20 per share. They think Blanch is "well positioned for a cyclical upturn in demand for reinsurance coverage." Edgar Blanch, the company's chairman and largest shareholder, believes the casualty market will firm up in the next 24 months. He expects catastrophe-property brokerage revenue to increase 45% this year, to $14.5 million. Demand from clients is such, however, that, were capacity not limited, revenues might have been $18.5 million.

Over the last five years, Blanch's revenues have increased 41% but earnings per share have grown 300%, as the company's operating margin has almost tripled, from 10% to 28% percent. But are these profit margins sustainable over the long term in a highly competitive business? Won't they shrink as the company grows? Guy Carpenter's margins, for example, have been under severe pressure the last six years.

Put simply: is the reinsurance business—and Blanch's reinsurance brokerage business—really on the verge of a boom, or is Wall Street simply in the midst of an outbreak of Reinsurance Euphoria? And, if Blanch's stock is such a good buy, why did its 51 shareholders choose to lighten up on the offering or shortly thereafter? That last question is, of course, somewhat rhetorical since these shareholders had paid, on average, $1.25 per share, and the opportunity to

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sell a portion of their holdings at $18.50 was, undoubtedly, tempting.

Perhaps our skepticism is misplaced; it's the optimists, after all, who tend to succeed. Perhaps everything will go right for Blanch: revenues may soar, expenses may remain in check, and the casualty market may be accommodating. Perhaps 15 times *projected* 1994 earnings is a fair price to pay for the stock. And perhaps Blanch's sky-bound earnings trajectory will continue for years and years.

On the other hand, maybe things won't work out *that* neatly. Maybe earnings will only grow 10%.

In that case, Edgar Blanch's sale of 39% of his stock for $27.4 million may seem especially shrewd.

Mr. Blanch's sale of his stock proved to be especially shrewd, and in the ensuing years he would demonstrate his shrewdness (when it came to selling his stock) time and again. On February 10, 1997, E.W. Blanch announced that it had purchased 750,000 shares from Mr. Blanch at $19.40 per share. Two months later, however, the company granted Mr. Blanch options to purchase 250,000 shares at $22.63 per share, and six months after that he got another 250,000 options at $31.38. Thus, Mr. Blanch managed to sell his shares yet still maintain almost the same upside potential in his company's stock. Outsiders, of course, got no such deal.

Last year, Mr. Blanch struck again, selling E.W. Blanch $700,000 of his shares at $44.31 a piece.

E.W. Blanch is now mired in problems. Revenues are shrinking, profitability is elusive, and many senior people have left the company. At its current price of $8, the company has a market cap (including debt) of about $160 million. Thus, instead of the market valuing Blanch at four times revenues—as it once did—the market now values Blanch at less than one times revenues.

That's progress.

E.W. Blanch: The Rise and Fall of Its Profit Margins

All figures are in millions of dollars, except earnings per share and number of employees.

		2000	1999	1998	1997	1996	1995	1994	1993	1992	1991	1990	1989	1988
Revenues	$	208.2	244.4	212.7	166.8	109.0	95.0	80.7	64.6	54.7	44.0	43.0	37.8	39.9
Net Income	$	(9.6)	39.7	31.8	25.7	6.3	18.2	17.1	13.0	9.2	6.1	4.6	3.2	2.3
Earnings per share	$	(.74)	2.89	2.42	1.99	.48	1.34	1.22	.97	.75	.50	.37	.26	.19
Tangible Net Worth	$	70.0*	72.7	80.2	41.5	51.0	27.7	11.3	47.7	4.2	4.6	8.6	7.8	4.5
Number of Employees		1,100*	1,291	1,164	1,130	648	566	603	349	329	279	298	302	305

*estimate