Brown & Brown, it’s not a shoe company or a theme park with wild animals. Brown & Brown is an insurance agency headquartered in Daytona Beach, Florida. Insurance may not sound as exciting as a theme park but stay with me on this company. As we look at this company, there are two questions you need to ask yourself:

Is it a good company?
Is it a company I want to invest in?

I spent the first sixteen years of my working career as an insurance underwriter for The St. Paul Companies and I feel I know the insurance industry pretty well. The employees of Brown & Brown are sales agents for insurance companies like Aetna, Hartford, and St Paul Travelers. They make money from commissions and fees on the products and services they sell. Unlike an insurance company, Brown & Brown is not a risk bearer. On average, an insurance company pays 70% of its profits in claims; an agency profits as long as it keeps and acquires clients.

Eye on Operations
The insurance industry has been consolidating for several years. In 2005, Brown & Brown made 19 acquisitions representing $121 million in forward annual revenues. This was on the heels of 22 acquisitions in 2004 representing $98 million in forward annual revenues. These transactions are important not only for boosting the growth rate but also Brown & Brown has acquired a lot of talented employees.
For an insurance company, 2005 was a disastrous year. As Hyatt Brown, the CEO told us on a recent conference call; disaster is actually an opportunity for an insurance agency. Brown & Brown grew closer to its clients because of the thousands of claims it handled in the wake of hurricanes that hit Florida and the Gulf Coast.

One-third of the business that Brown & Brown writes is in Florida. In many cases, the company underwriters don’t know what their Home Offices want to do relative to property insurance in Florida and how it will affect their underwriting strategy. In some cases, the agent will be in the middle of making a proposal to a client and the company underwriter says no, I can’t write the account. Insurance premiums have risen 40 to 100% on surplus lines business. Deductibles are a percentage of the building value. It takes about six months for the Home Offices to adjust their underwriting strategy. Brown & Brown expects premium increases and more restrictive policy terms by April.

Despite the stress on agency employees who worked to handle thousands of claims, the company posted exceptional results. For the fourth quarter ended December 31, 2005, revenues were up 20.7%. Earnings per share were up 16.3%. The primary drivers of growth were commissions and fees, which increased 22.5% and investment income, which doubled in the fourth quarter to $2.3 million. Investment income is the money that is earned on collected premiums that sit in an interest bearing account until they are paid to the insurance companies. Thanks to rate hikes by the Federal Reserve, the yields on interest bearing accounts are rising.

While total revenues grew by 20.7%, expenses grew by only 19.9%. Pretax margin rose by one-half percent to 29%. The single largest expense item for Brown & Brown is employee commissions and benefits. As a percentage of total revenues, this line item was 49% of total revenue or a one full percentage point lower quarter over quarter.

For the full year, revenues rose 21.5% to $785 million. Earnings per share were up 16%. The balance sheet is solid with $100 million of unrestricted cash. Shareholders equity increased 22%.
Brown & Brown’s biggest concentration of accounts is in the middle market, that is small and mid-sized commercial businesses. These businesses are growing rapidly and generate high margins for the agency. They like to sell custom accounts that generate $2,500 to $7,500 in commissions because these clients are the most loyal. The company also collects consulting and processing fees as a third-party administrator of workers compensation and health care plans. Brown & Brown recently started a new division to sell insurance to cities and townships. The majority of its clients reside in Florida, California, New York, Georgia and New Jersey.

J. Hyatt Brown joined his father’s agency in 1959. He left for eight years (1972-1980) to serve in the Florida House of Representatives and then returned to the agency as chief executive officer. Hyatt Brown is credited with developing a culture where everyone is measured on an equal basis. “It’s not what you did for me yesterday, it’s what you do for me today.”

Spitzer Raises His Hackles
The insurance industry typically goes through two-year pricing cycles, either a hard market where it is easy to raise insurance premiums or a soft market, where it is very difficult to raise premiums and not lose clients. The events of September 11, 2001 have allowed insurance companies to benefit from a hard market for the past four years.

New York Attorney General Eliot Spitzer blew the whistle on insurance companies who paid bonuses to brokers for placing business through their companies. The practice, called bid rigging, had been going on for quite some time before Spitzer cracked down. Brown & Brown was not accused of engaging in the practice but its stock, nevertheless, traded down in sympathy with companies such as Marsh & McLennan who willingly accepted bribes.

Pricing Power
As a result of the hurricanes, Hyatt Brown and his colleagues expected that the capacity for writing commercial insurance in Florida would be reduced. That is occurring to some degree but
it isn’t crimping agency profits. “Pricing is edging up a little and we’re seeing some additional changes in terms and conditions such as increased deductibles,” he admitted.

Capacity is shrinking in the Florida homeowners market. In many cases, the only insurer who is writing homeowners’ insurance is the Citizen Insurance Company, which is run by the state of Florida. In California, for a period of almost two years, Workers Compensation was very tight, meaning capacity wasn’t available. All of a sudden, it’s becoming more competitive as more insurance companies are willing to write Workers Compensation in the state of California.

The Outlook
Brown & Brown’s stated corporate objective is to increase net income per share by at least 15% per year. The intermediate goal is to achieve B-40, that is, $1 billion in revenues and a 40% operating margin. A softening in the market is now less likely because insurance companies will have to pay higher reinsurance premium, their investment yields will remain low compared to historical returns, and their reserves for claims will have to rise to maintain their credit ratings. Good expense control should keep Brown & Brown’s operating margins at a high level. While the internal company growth rate is likely to stay at 5 percent, the company’s aggressive acquisition strategy should allow it to achieve its growth targets.

Turning to the Stock Selection Guide, I like graphs where the sales, pretax profit and earnings lines are all trending up. I like a company where the insider ownership is fairly high at 21% and where the debt level is manageable at 26%. Considering all the turmoil in the insurance industry, the fourth quarter sales growth of 20.7% and EPS growth of 16.3% were phenomenal.

I wish all my PERT graphs looked this good where all the fundamentals are steady! As you can see, pre-tax profit as a percentage of sales has been close to 30% for the past 4 to 5 years.
The average rating of the ten analysts who follow the Company is a hold. Firming interest rates are boosting investment returns and higher prices for insurance products are boosting commission income. Yahoo and Reuters project that the company will grow its earnings at a 16% rate over the next five years. I’ve chosen to follow the company’s guidance of 15% to account for uncertainty in underwriting strategies. As you can see, S&P agrees.

Pretax profit is trending up at 31% while return on equity is trending down but a respectable 19.7%.

Brown & Brown is currently trading at a price/earnings ratio of 29. The five-year average high and low P/Es are 29.1 and 18. I’ve chosen to average the high and low P/Es for 2005 and 2004 to come up with high and low P/Es of 27.3 and 18.3.

At 25/50/25 zoning and a current price of $31.25, BRO has an upside potential of 2.4 to 1 with a buy below price of $30. That puts the stock outside of our buy range. The projected annual return (PAR) is 10.3% and the total return is 14.2%.
This is not a recommendation. To decide if Brown & Brown is the right investment for you or your club, I encourage you to order an investment packet from the company and listen to the next earnings conference call. A full copy of my stock report is available on the Crow River Investment Club website.

Your questions answered Ssostar@comcast.net
Brown & Brown has made solid progress of late. Share earnings rose 16% in the most recent year, boosted by steady growth in commissions and fees. 2005 was the 10th consecutive year that the company recorded earnings gains of at least 14%. Acquisition of small insurance companies also continued to benefit the top line, as the company closed 19 transactions for the year, representing $121 million in forward annual revenues. Moreover, decent revenue gains in the core business were driven higher by sales in the company’s insurance services.

We expect the insurance premium rate environment to remain relatively soft in the next few years. Insurance rates across most segments of the industry may not show any special strength in the coming quarters, especially as competition intensifies. This will likely lead to slower growth of commissions and fees at Brown & Brown. On the other hand, acquisitions may serve to lift revenues and offset the slowed premium rate environment.

Given the company’s history, we have factored in a small amount of takeovers into our projections. Meanwhile, ongoing expense controls should help to keep the company’s operating margins above 38% in the years ahead.

Prospects over the coming 3 to 5 years are bright. The top and bottom lines will probably advance between 10% and 15% annually during this period, as the company’s growth strategy will continue to benefit from acquisitions and internal growth. Furthermore, the company has a strong financial position to support its strategy. Nonetheless, this stock changes hands at a relatively high P/E ratio, which is currently trading with the lower end of our 3- to 5-year Target Price Range.
VISUAL ANALYSIS of Sales, Earnings and Price

SALES ($M)  ($)

EARNINGS PER SHARE ($)

Latest Quarter  196.9  0.25
Year Ago Quarter  163.0  0.22
Percentage Change  20.7%  16.3%

See Chapters 8, 9, and 10 of the BetterInvesting Official Guide for complete instructions.

Use this Guide as working section of BetterInvesting Stock Selection Guide & Report.
EVALUATING MANAGEMENT

Company: BROWN & BROWN INC Iowa (BRO)

<table>
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<tr>
<th>Year</th>
<th>Average Total Annual Return Over the Next Five Years %</th>
<th>Average Yield %</th>
<th>Annual Appreciation %</th>
<th>% Earned on Equity (E/S ÷ Book Value)</th>
<th>% Pre-tax Profit on Sales (Net Before Taxes ÷ Sales)</th>
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<td>2005</td>
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Note: Results are expressed as a simple rate; use the table below to convert to a compound rate.

this combines price appreciation with dividend yield to get an estimate of total return. it provides a standard for comparing income and growth stocks.

P.E. = 123.3% Proj. Relative Value: 106.6%

5-YEAR POTENTIAL

This combines price appreciation with dividend yield to get an estimate of total return. it provides a standard for comparing income and growth stocks.

A Present Full Year's Dividend $0.200

Present Price of Stock $31.250

Present Yield or % Returned on Purchase Price 0.6% (5A)

B AVERAGE EARNINGS OVER NEXT 5 YEARS

Avg. Earnings Per Share Next 5 Years 1.64

X Avg. % Payout 16.3 %

C ESTIMATED AVERAGE ANNUAL RETURN OVER NEXT FIVE YEARS

5 Year Appreciation Potential (4E) 89.4

Average Yield (5B) 17.9 %

Average Total Annual Return Over the Next 5 Years 0.9 %

% Compd Ann Rate of Ret 10.3% 14.2%

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