

Maximizing Agency Value By Harnessing The Opportunity In Change

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Innumerable factors impact the value of an insurance agency. While the external and internal factors may have changed over time, one constant remains - an agency with effective leadership, planning, accountability and execution will drive value regardless of the market conditions. While external market factors are hard to predict, they do influence internal factors such as growth and value. In the following pages, we will present a high-level overview of the major factors impacting agency value in the past, present and future. Agencies that are successful in commanding control over these factors will be the winners in driving agency value and sustainability.

The Past

Over the last 40 years we have witnessed three hard market cycles: 1975-1978, 1984-1987, and 2000-2003. During these periods, many agencies surfed the wave as rates, revenues and agency values increased despite the fact that most agencies operated with a “business as usual mentality.” Additionally, in 1999, the Gramm-Leach-Bliley Act deregulated the market and brought an influx of buyers into the insurance marketplace. A bevy of banks, public brokers and private equity firms entered the market, hungry to establish a foothold in the insurance space. This increased demand drove up the value multiples that were paid for agencies and, once again, the rising tide lifted all boats. Even those without a captain. The past as we knew it came to a screeching halt when we entered into the “Great Recession” beginning in December of 2007. A convergence of many factors including the credit crunch, the housing slump and a contraction of the labor market put the brakes on the U.S. economy. Since 2007, the survivors have focused on ways to endure the current market debacle. While improvement is now being seen in the economy, the emphasis on surviving has redirected time, people and resources as some agencies are focusing on where they are headed for the future. Agencies with keen foresight will use the opportunities afforded by the current market to position themselves to survive now and thrive in the future.

The Present

The uncertainty and losses related to the earthquake and tsunami in Japan are unknown. Lost lives and destroyed families paint absolutely tragic scenarios. Financially, loss estimates are coming in now around \$10 – \$50 billion. Due to the nuclear disaster that followed the earthquake and tsunami there is still limited information coming out of Japan. As such, this estimate may increase in the future as more information becomes available. Additionally, predictions for a very active hurricane season have been made. According to Colorado State University meteorologists, 17 tropical storms are predicted with 9 developing into hurricanes. This is slightly below the hurricane season of 2010 but above the average of 6 hurricanes in a typical year. These are all external factors in which an agency does not have control. For this reason, an agency must focus on the internal factors that can be controlled – items such as growth, profit, balance sheet stability, just to name a few.

Capturing market share, in other words growth, remains a key focus for agencies to drive returns. This is also embraced by insurance companies. According to research by the Ward Group, approximately 40% of insurance companies plan on revamping agency compensation plans via increased premium volume

requirements, adding growth requirements, changing contingent plans, etc. Thus, the key difference between the best and the worst performers relative to value enhancement will be a direct result of proactive versus reactive management.

Clarity can be found regarding some external forces. Performing research is the best way to learn about what may happen in the future. Based solely on the examples given above, we know what will happen regarding some external forces (hurricanes, company actions, etc.). Use this information as well as other nuggets learned to position your organization for the future. Then, find the opportunity that is presented in the coming change.

Over the past 24 months, many agencies implemented short-term cost saving initiatives in hopes of preserving profitability but, instead, destroyed organic growth and long-term sustainability. Servicing staff hiring freezes, wage freezes and a moratorium on producer reinvestment was hastily implemented in order to improve short-term margins. Many had to do this to survive—and rightfully so. However, this strategy, when implemented as short-term cuts versus long-term strategic controls, has instead set the table for valuation freefalls for many. Despite these initiatives, profitability will slip due to revenues declining faster than expenses can be cut. In these situations, it is very rare to see any business be able to cut expenses faster than revenue declines.

The harsh reality is that too many agencies are implementing short-term plans to try to preserve margin without a strategy to maximize long-term value appreciation. Owners are essentially managing wasting assets. In other words, most are putting a bandage on the problem. It is now time to rip off the bandage – however painful that might be.

Here are some ways high performing agencies are healing the wounds left by the market. The leading agencies continue to:

1. Hire production talent – a never-ending process of hiring talent.
2. Train all levels of the firm from support to production.
3. Deploy capital on investments such as new producers, quality staff and acquisitions.
4. Drive organic growth. For example, a producer may be required to produce new business that is equal to at least 15% of their prior year book of business or else face negative consequences to compensation.
5. Maintain producer accountability systems and use as a tool to manage the production staff.
6. Embrace strategies to differentiate themselves from the competition whether by having a great elevator speech or providing service timelines and stewardship reports to clients.

The top 25% of insurance agencies are performing well, despite the external environment and will continue to reinvest, thrive and perpetuate. In short, peak performing agencies control their own value versus letting the marketplace dictate. Those owners who are choosing to have their agency be an appendage to support a lifestyle will sell via an auction bidding process. Unfortunately, outsiders will ultimately control and determine their value.

The Future

The overall numbers of agencies are declining; however, the decline is yielding an increase in numbers of larger agencies (greater than \$5.0 million revenue). Smaller agencies are disappearing and existing agencies are getting larger. MarshBerry predicts the total number of insurance agencies to drop to just over 22,000 by 2020 from just over 28,000 in 2010. The decline is not a product of agencies filing for bankruptcy. Rather, it is a byproduct of carrier pressure and economies of scale, just to name a few. We see quite a few agencies selling or merging – in many cases insurance companies orchestrate the merger. Given the external factor that agency consolidation will continue, what can your agency do to capitalize on this trend?

For the vast majority of agencies, value is inextricably tethered to the internal and external dynamics of the marketplace. Historically, agency value tracks lockstep with the fluctuations in P/C Net Written Premium volume. And while this is good news during hard markets, it is unwelcome news during soft and declining markets. The reality is that hard markets are the anomaly and soft markets are the norm. Those complacent agency owners who sit back and wait for the next hard market to come and buoy their agency value will not survive, as their value will be determined by external forces. Those who focus on what they can control will determine their value in the marketplace.

Conclusion

As the world around us continues to change and evolve, so too does the insurance marketplace. But change can be good. The operating environment under which thousands of agencies thrived over the last several decades will not be the same model necessary to survive in the future. The minority of agencies will sustain value by proactively managing revenue and earnings through education, change, planning and accountability. For the majority, macroeconomic factors such as the economy, the regulatory environment, premium rates and the prevailing merger & acquisition dynamics will drive internal value.

Take time to look into your personal crystal ball. See your agency's future. Then plan to turn your current reality into your preferred state. Determine what you can and cannot control. Control what you can and then find the opportunity in what you cannot control – exploit it. We at MarshBerry are pleased to share with IBANY partners the metrics and practices being employed by the nations leading agents and brokers to drive equity enhancing change during the next presentation series.