

# THE MARSHBERRY LETTER

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## Agency Ownership - A Great Investment Option

*"There has never been a better time to invest in an independent insurance agency."*

For the past three years, we have stated that now is a great time to invest in an independent insurance agency. And for the fourth straight year, we again make that statement. When compared against alternative investment options, independent insurance agencies continue to realize steady value increases over time. Of course, like any investment, there are periods of strong gains and periods of stagnation.

The average fair market value increase of our ESOP agencies

did slow in 2004 but rebounded during 2005 with a solid 8.9% return. In the end, ownership of an insurance operation is a long term deal and the rewards are worth the investment. We know it. You as agency owners also know it. Now it's time to make sure that perpetuation candidates believe it.

In the business world, those who embrace opportunity thrive. Those who do not, often find themselves wondering what went wrong. Therefore, before we show you the annual update of investment options, we will discuss the challenges and opportunities that the current insurance marketplace presents. Only by understanding external market factors can agency owners continue to turn these external challenges into internal opportunities.

## Market

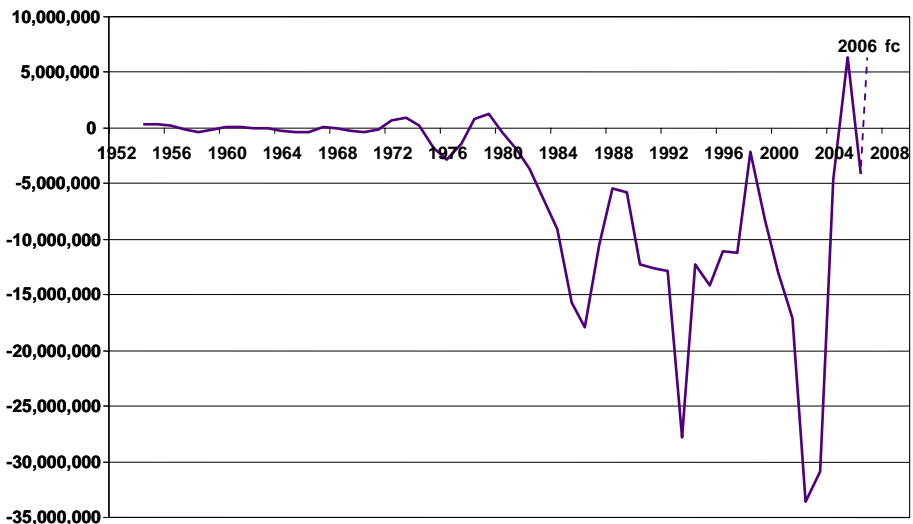
The P&C soft market is here to stay, with no relief in sight. Even after a horrific year of losses, the storm clouds of insurer balance sheet stability, interest rate increases and rate adequacy have converged to create a rate reduction thunderstorm. Specifically, insurance premium growth of 1.8% during 2005 was a mere fraction of the 2002 hard market peak of 14.8%.

While the \$60 billion hurricane loss hit to the underwriter and reinsurance market was significant, the losses merely offset the huge underwriting profits realized during the first half of 2005. As a result, we are not seeing any hard market across the board. On the contrary, price hikes for 2006 are largely confined to those lines most susceptible to catastrophic losses. Estimates suggest that P&C premium growth will total, at best, 3.5% during 2006.

As you contemplate how long the brutal rate environment may last, consider that the soft market began before the insurance companies knew they could afford it (interest rates were declining, companies were posting underwriting losses and surplus had suffered a multiple year decline).

Today's metrics suggest that the current rate environment is likely to get worse before it gets better.

Historical P&C Underwriting Profit



P&C insurance company surplus improved to a record high of \$427 billion during 2005, despite the hurricanes. According to ISO and the Property Casualty Insurers of America, surplus increased to \$440 billion at the end of the first quarter 2006.

The latest projections suggest that 2006 will be the second year since 1978 to show an underwriting profit. Through the first quarter of 2006, the ISO and PCI report P&C net underwriting gains of \$8.6 billion.

To top it all off, the Federal Reserve has raised the benchmark federal funds rate 15 straight times since 6/30/04. What does all this mean? When surplus and rate converge with an increase in interest rates, you get a marked increase in carrier investment income and hence cash flow underwriting.

The difference between historical cash flow underwriting cycles and this is the fact that carriers are now adding stricter underwriting requirements to the mix. Stricter underwriting results from Wall Street puts pressure on insurers to increase 2005 return on equity from 10.5% to numbers more aligned with those of Fortune 500 companies in the 15% range. As a result,

insurance companies are plotting to improve efficiency to support further rate reductions by increasing volume requirements and maintaining fewer appointments. Despite the historic trend of expanding agency appointments in a soft market to capture investment dollars, carriers are now dictating increased underwriting stability as they seek to drive ROE gains.

If the stock market continues to gain momentum and underwriters feel they can count on an increase in their equities portfolios along with underwriting profits, it could be devastating for small, low-growth agencies.

Capacity will be reallocated and reserved for larger players that have good loss ratios, commit to volume increases, and have an organic growth culture and production staff that can support profitable premium growth. Will you remain in good favor with the underwriters? Do you have an organic growth culture?

Additionally, carriers are tiering the distribution force, not only in terms of volume and underwriting profitability, but also in terms of perpetuation ability. And perpetuation is driven by sustainable agency revenue and earnings growth that can help

fund the stock transfer process between shareholders at a fair price. Those agencies that have reinvested in their production staff, are well positioned for perpetuation and are experiencing profitable organic growth are the darlings of the insurers. Those that have not will be weeded out of the system at an increasing rate.

Many of your peers are not standing by watching the market change. Public brokers, while achieving poor organic growth, have successfully closed acquisitions to drive total growth and remain in favor with underwriters. The 30 largest bank-owned agencies in the country increased revenue from \$400 million to \$3.5 billion in 5 short years through a combination of acquisition and organic growth. Large independents have fared better than the brokers in organic growth but cannot seem to compete for deals.

The storm is raging and change is the only constant. One certainty that will prevail through the sea of change is those that can produce will thrive and drive agency value. It is time to focus.

For leading agencies, average revenues, contingencies, and

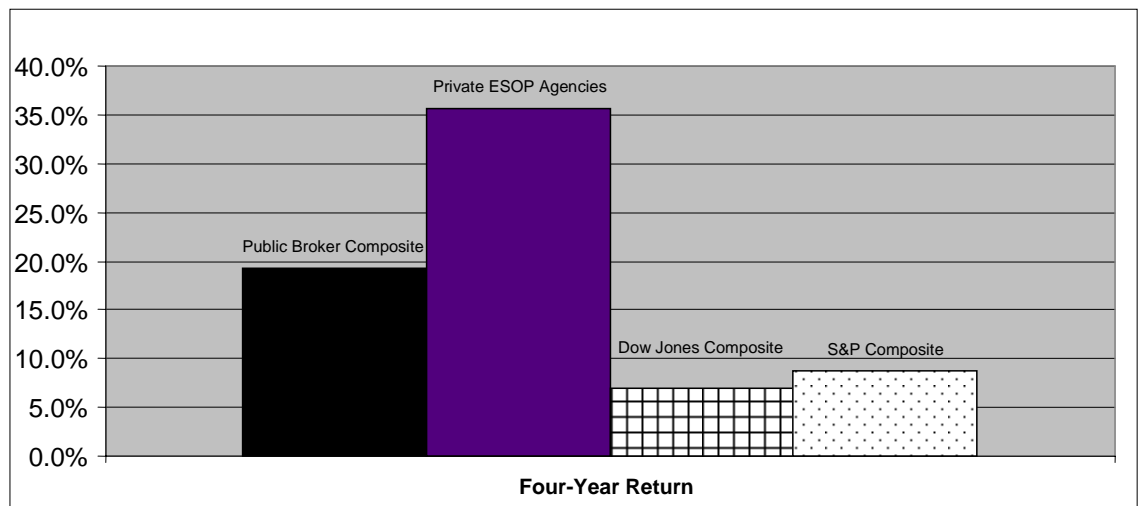
**Three-Year Total Return (12-31-01 through 12-31-05)**  
*Independent Agency Investment vs. Alternatives*

	Initial Investment 12/31/2001	Average Unit/Share Price 12/31/2001*	Number Units/Shares Purchased	Average Unit/Share Price 12/31/2005	Four-Year Accumulated Investment	Four-Year Total Return
Public Broker Composite	\$100,000	\$ 28.09	3,560.24	\$ 33.50	\$ 119,282.26	19.3%
Private ESOP Agencies	\$100,000	\$ 3,847.26	25.99	\$ 5,220.34	\$ 135,689.90	35.7%
Dow Jones Composite	\$100,000	\$ 10,021.57	9.98	\$ 10,717.50	\$ 106,944.32	6.9%
S&P Composite	\$100,000	\$ 1,148.08	87.10	\$ 1,248.29	\$ 108,728.49	8.7%

\* Assumes an investor is purchasing one share of each individual stock in portfolio

\* 12/31/01 Starting Average Unit/Share Price may vary from prior years due to adjustments for stock splits and timing of agency valuations

profits are at an all-time high. However, average organic growth rates are declining. As agencies have focused diligently on expense management over the past several years, meaningful future profit expansion from additional cost cutting measures may be limited for many.



The hard market four years ago fostered a certain degree of complacency within the agency sales culture as organizations were growing without selling. Yesterday's complacency helped fuel today's growth mediocrity. The softening rate environment, increased competition, transparency and disclosure and renewed shareholder demands for a fair investment return are changing all that. Top line growth remains a necessity to enhance carrier clout, drive earnings, provide reinvestment capital, and ensure survival.

Most agencies' new-business production capabilities are not strong enough to make up the difference between premium rate increases and internal growth objectives. Leading agency budgets call for 10.5% total growth in 2006, which is commendable based on shareholder return expectations. When compared against the average expected premium increases of 3.5% or so, these leading agencies need to net 7.0% growth. Considering typical attrition of 8.0%, these leading agencies plan on selling new

business equal to at least 15% (7.0% net plus 8.0% attrition) of the prior year's revenue.

Are you taking control of your investment? Imagine the day when you begin your budgeting process with double-digit net organic growth as a minimum REGARDLESS of external market factors. The agency is often the largest asset of its stockholders. As investors, you mandate certain financial returns for your market portfolio risk. The stock appreciation value of your agency should be no different. But unlike general stock portfolios, your agency investment is in your direct control. Remember, the ability to maximize sustainable and predictable growth is directly correlated to agency value. The most pressing challenge facing insurance distributors in 2006 is creating a new-business production machine to drive organic growth—or finding a partner that can. This will be a watershed year for many independent agencies, which must determine how much of their earnings they want to reinvest in infrastructure,

including production talent, to fuel growth and build organizational viability. Those who do are well positioned for continued long term value increases.

### ***Outlook for the Road Ahead***

Consolidation will continue to permeate the industry because of both buy-side demand as well as sell-side necessity. Buyers need total growth enhancement and those who have to sell cannot realize organic growth. The number of agencies attaining over \$500,000 in agency commissions will fall from approximately 11,700 in 2005 down to 8,500 by 2015. Agency competition is getting larger and size matters.

Publicly traded competitors have advantages of acquisition capital, resources and expertise. They maintain thousands of core customers through which to target cross-selling activities. They also have outside investor pressure that mandates certain levels of revenue and earnings growth. How will you compete?

By reinstating a sales culture. Combining high revenue growth with strong earnings growth is a challenge. But it is also a necessity for those choosing to control their future.

Transparency and disclosure has solidified itself at the forefront of the industry over the last year and a half. As some public brokers have sworn off contingents and will "sell" this to prospects, disclosure also presents a great opportunity for agencies. The nation's highest growing agencies appear to be the most vocal and proactive regarding the communication of agency commissions and fees. We suspect that this is partly due to regulatory risk mitigation, but the extent to which they communicate commissions and fees signifies that they are also comfortable with the agency-insured consultative service value proposition.

Agencies will be increasingly forced to justify compensation through value-added services and differentiation platforms. Those pioneering the financial justification strategy will be best positioned to sell both price and service. While almost 70% of high-growth agencies state that they maintain a defined stewardship reporting process with a listing of value-added services, timelines and responsible individuals, few agents and brokers are currently driving down this road. A huge competitive advantage awaits those in the driver's seat.

Those taking advantage of these opportunities will continue to realize revenue and earnings growth. Such growth is necessary to fund perpetuation at a fair price, position the agency for long term sustainability, and create a desirable investment option for the next generation of owners.

Have you prepared for a continued soft market? Do you have a well oiled producer management process centered on hiring, training, accountability and differentiation? Are you prepared to defend your compensation to insureds with service timelines and stewardship reports?

While many agency owners can answer yes to most of the above questions, most recognize that now is the time to fine tune the engine to drive predictable revenue and value growth. In the next two issues, we will take a detailed look at the independent agency environment as a whole and then discuss specific organic growth tools that agency executives can employ to turn market challenges into agency value enhancement opportunities.

### **Buy Low – Sell High**

Over the last couple years, we have shared with you a chart that illustrated the returns of four separate potential investments; the Dow Jones Industrial Average (DJI), the Standard & Poor's 500 Index (SPX), a public

broker composite, and a composite of ESOP agencies that we value on an annual basis. The public brokers selected for comparison are those who were trading at 1/1/2002 and who remained active as of 12/31/2005. They include Hilb Rogal & Hamilton (HRH), Arthur J. Gallagher (AJG), Marsh & McLennan (MMC), Brown & Brown (BBR) and Willis Group Holdings (WSH).

The basic assumption in our model is that a person had \$100,000 to invest in any one of the four funds listed above on New Years Day 2002. If all monies were invested in one index, which would have shown the best return?

An item of note: Due to the timing of year-end 2005 ESOP appraisals and adjusted figures for public broker stock splits, the beginning average unit share prices may differ from year to year.

Finally, we told you that we would update the exhibit annually and keep you informed of the results. Here they are. Be proud of your accomplishments. Share these numbers with future owners. And continue to proactively drive agency value.

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## **The MarshBerry Letter**

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