

Growth Determines Retail, Wholesale Broker's Value

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Sustaining Progress in a Changing Rate Environment

The wind has been at the back of insurance agents and brokers for the past several years and has resulted in smooth sailing. Organic growth rates have been in double digits for most operations. Retail agencies have reaped the rewards of increasing rates. Wholesalers have benefited from decreased capacity from the standard markets as the retail agents search for alternatives to place accounts. Owner return and value is at an all-time high.

Given the current agency climate of rate softening, carrier tiering and increased consolidation, today is the day for self-evaluation. It is critical that each agent or broker determine where you are going and how you are going to get there. The commitment must be made by the owners to develop a plan for sustained revenue and earnings growth as the insurance environment changes. Both top-line and bottom-line growth are the key to value and are necessary to perpetuate your business. Growth will ensure your independence for the future.

Consider the market as it stands today. Most standard lines carriers have repaired their balance sheets and are prepared to focus on growing premium through increased capacity. Their surplus positions are at record levels and will result in a change in the appetite for business. As a result, rates on many surplus lines of business will decrease as they shift to the standard lines.

Excess and surplus lines rates remain hard but the end is near. It is only a matter of time before the increased capacity in standard lines and changes in appetite affect the volume of business that is placed in the E&S market. When this time comes, the wholesale marketplace will need to look to alternative sources to drive internal growth and maintain agency value.

The growth in commissions and fees has led to record level profit margins for both retailers and wholesalers. Operations have increased in efficiency by maintaining the number of service staff to handle the larger volume of premium dollars. MarshBerry statistics have shown that retail agents have increased profit margins well above 25% of revenues and wholesalers are now exceeding 30% on average. Since value is directly related to profit margins, agency valuations are at an all time high.

Understanding how the increased profit margins impact valuations is important as you evaluate future expansion. Valuations are based in large part upon a multiple of operating profit. As operating profit increases, so does the value of the firm. If rates begin to decline, the same service and overhead dollars will be needed to administer those accounts. The margin on maintaining your current accounts will decrease and so will the value of that business. Top-line growth through new business is the primary way to combat decrease in rates.



With valuations at an all time high, many of your competitors have elected to sell rather than reinvest in the business to maintain independence. The public brokers and banks that have traditionally concentrated on standard retail agencies are being impacted by the soft market and are aggressively pursuing

wholesalers as a means of sustaining revenue growth and profitability. Wholesalers provide them with opportunity to acquire businesses with a traditionally higher profit margin and another link in the insurance distribution channel.

ORGANIC GROWTH RATES

	Public Brokers	Bank Owned Agencies	Independent Retail Agencies	Wholesale
2002	12%	14.5%	17.1%	30.3%
2003	9%	11.5%	12.7%	27.9%
2004 (Estimated)	0%	5%-10%	7%-10%	10%-15%

Understanding the market factors in play today, you are faced with a decision of your future. You can do nothing, which is equivalent to a death wish for your business. You can cash in on your current agency's value while the terms are good and the prices are high. Or you can invest in your future by making the commitment to grow revenues and use the excess profits to strengthen your balance sheet, reinvest in the agency, and ultimately secure long-term independence.

The commitment involves implementing several important goals into your operation. First, you must develop a total agency sales culture that focuses on organic growth. Second, the business must recruit, replace and retain the top talent. Third, the shareholders must focus on building balance sheet strength by having the business retain earnings. Fourth, the operation must build a mechanism to support cash flow necessary to fund perpetuation.

The four disciplines will reduce the risk to the current owners for an eventual internal sale

while maximizing the return they can receive from perpetuation. The owners will be able to hold a note with confidence because the agency will have the continuity of cash flow to fund the perpetuation process. It will have the diversified talent to continue to grow the business and there will be adequate capital to ensure the financial health of the organization.

The first discipline that must be implemented is that the business must become a sales organization. We all remember Econ 101, which taught us that an organizations revenues can be increased in one of three ways: 1) Raising price 2) Selling more products or 3) Bringing a new product to market. As your rates and product offerings are fixed to a large extent, selling more products is the most immediate and relevant strategy for your agency today.

During the hard market, many operations relied on increased rates to fund organic growth. With a change in the rates, the operations must look to other sources to drive revenue growth. While retail agencies focus on new business



production, wholesalers are relying on new program development, implementation of technology to reach a new customer base or expanding the network of agents through direct marketing or advertising. Shareholders must drive the concept that the management or production team of the organization is accountable for seeking alternative sources of revenue and cannot rely on the current revenue sources for increases in value.

Locating and retaining top talent is a source of concern for all organizations. In order for an agency or brokerage to perpetuate, there typically needs to be two buyers for every shareholder that wishes to sell. Traditionally, an organization will hire three individuals for every one employee that is considered a success. This translates into a six to one ratio for internal perpetuation. Given these statistics, it is essential for operations to provide the appropriate incentives and work environment to attract, train and retain top personnel.

Typically, providing the right incentives to individuals is an expensive reinvestment for the current shareholders but will pay dividends in the long run as the agency continues to grow, the employees maximize their W-2, and the agency rewards (shares ownership with) those employees who consistently contribute to the increasing value of the agency

The average wholesaler is undercapitalized. With limited access to outside capital, shareholders committed to perpetuation must also focus on growing the tangible net worth of the corporation. Perpetuation requires an agency have, at a minimum a tangible net worth equivalent to 25% of revenues. We define tangible net worth as equity of the agency less any intangible assets. Reaching this level is done by establishing a plan to retain a set level of revenues in the organization each year. Shareholders must realize that tangible net worth in the organization is an investment in the future of the business.

AVERAGE AGENCY CAPITAL POSITION

Tangible Net Worth	11.4% of Revenue
Net Fixed Assets	9.8% of Revenue
Notes Receivable from Shareholders	4.5% of Revenue
Liquid Tangible Net Worth	(2.9%) of Revenue
Perpetuation Minimum	25% of Revenue

Finally, the agency must develop a mechanism to generate enough cash flow to fund a perpetuation plan. Perpetuation is often seen as a single transaction or a snapshot in time. However, perpetuation is a continual process that exists throughout the life of the operation. The process should focus on transferring the owner's individual books of business, the leadership of the agency and the stock gradually to the individuals that are driving

value. When coupled properly with growth goals, this process can result in increasing shareholder value for all participants.

One such process that ties growth to ownership is the Perpetuation Stock Incentive Plan ("PSIP"). The PSIP rewards the performers in the operation with the opportunity to become equity partners. Individuals must grow the revenue that they contribute to the agency on



an annual basis to participate in the plan. The percentage of ownership that they are able to acquire is directly related to the amount of new business that they bring to the operation. Growth is the key to participating in the plan.

By focusing on reward through growth, the PSIP when implemented is designed to:

- Test broker willingness to accept perpetuation debt
- Reduce risk associated with need for an inevitable sale
- Increase broker / spouse comfort with managing perpetuation debt
- Teach brokers to keep lifestyle costs in balance
- Incentive for brokers to increase net growth beyond 15% target
- Outline personality traits and performance required for ownership

- Enhance perceived control over stock ownership and net worth
- Drive value by enhancing production of new and current brokers
- Increase attractiveness of agency to external and internal buyers
Accretive to the value of existing shareholders

The production staff will be able to increase their interests in the agency by continuing to meet certain criteria on an annual basis. The criteria are established at during the implementation of the plan and are communicated to each potential participant prior to each year of the plan. The current shareholders must determine what criteria they feel is important to be a partner within the organization. The criteria should reflect the culture of the organization as well as the values of the current management team. An example of plan criteria is as follows:

PERPETUATION STOCK INCENTIVE PLAN

Objective Criteria Examples	Subjective Criteria Examples
3 + years of experience in the industry	Ability to communicate with agency employees
3 + years of service with the agency	Displays skills with respect to new business, account handling, leadership & management
Individually developed a revenue stream of \$400,000	Committed to the future of the industry and agency
Reached a set new business goal during the previous year	Self-starter regularly demonstrating initiative
Signed a non-solicitation agreement with the agency	Positive attitude
Satisfy an employee survey	Field underwriting that demonstrates diligence and integrity



At the end of the first plan year, all individuals are evaluated to determine if they met the required criteria. If it is determined that they met the outlined criteria, they receive a stock bonus. The individual is required to pay the taxes related to the stock bonus. In addition, they will be able to purchase an amount of stock related to a percentage of the new business that they brought to the organization. They would typically purchase the stock over a five-year vesting period to ensure their long-term commitment to the agency. Each subsequent year, all producers are compared to the plan criteria to determine if they have met all requirements and are able to purchase another block of shares.

Annual participation is tied to the amount of growth in the organization attributable to that

individual and they are only able to participate if they continue to be a contributor to the entity. For many businesses, a plan of this nature will keep the staff focused the importance of top line growth as a driver of value and maintaining independence.

With the wind changing direction, your agency is at a critical decision point in your journey. Your agency can longer rely on rate increases to improve revenues and sustain value. The growth and value in your operation lies in the skills of the management and production talent that exists in the agency and the commitment of management to search for new sources of revenue. Now is the time to decide which of your crew are skilled masters of the sea that can assist you in maintaining your plotted course.

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Paul Vredenburg, CPA, is a Senior Vice President at MarshBerry with expertise in the areas of :

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