For The Manager

John M. Wepler

When divesting, prepare to maximize value

LAST MONTH'S column considered many of the actions an agency manager must take to prepare an agency for perpetuation: An agency must continually reinvest in the staff; recruit, retain and reward performers; remove barriers to cash flow; retain earnings; and relinquish stock gradually to those deemed worthy of an ownership interest. When these important steps are taken, an agency is better able to remain independent amid the ongoing industry consolidation.

While continuous preparation is a necessary component of the perpetuation process, it does not ensure success. Many agency managers follow a detailed perpetuation plan for decades but fail to perpetuate ownership internally. Why? Because they often overlook a critical issue that is very difficult to resolve in advance: Will key employees rise to the occasion, take the risk and sign the perpetuation note? High-quality, forward-thinking producers, employees and minority shareholders often promote themselves as interested buyers. They believe they will be able to accept the challenge, yet they turn out to be too risk-averse to actually follow through.

Many principals have experienced this dilemma. They have improved their agencies and overcome their natural resistance to broaden ownership. But despite their earnest efforts, they still cannot perpetuate their businesses. These principals are left with two alternatives: a merger or a sale to a third party. This column will outline a few of the many critical issues that should be considered by an owner prepared to perpetuate but forced to consider a sale for lack of a commited buyer within the agency.

Plan for the sale

An agency principal often dedicates a sizable portion of his or her life to building a business, but then devotes less than a year to divesting himself of the agency in a sale to a third party. In most cases, the time is used to find a buyer and negotiate terms, rather than to embark on a well-defined plan to increase value. The proceeds of a sale reflect the culmination of a lifetime of effort, boiled down to one number. Prior to starting the sale process, an agency should engage in an arduous three- to five-year effort to maximize that number.

An agency owner who fails to plan for a sale is like an exhausted marathon runner walking the last 50 feet to the finish line. Long before reaching the 26th-mile mark, a runner should assess physical strength, identify adjustments that can be made to increase stamina and speed, formulate a finish-line strategy and find the adrenaline to complete the task. An agency owner considering a sale should be no different.

An agency committed to a sale should strive to identify and improve those areas that will have the greatest impact on agency value. Clearly, there are a large number of issues to review. Among the most important, yet often overlooked, are collections and producer vesting.

Collections

A seller should focus intensely on formalizing and improving collection procedures. Capable buyers consider an agency's ability to collect funds and its proficiency at investing them to be key indicators of its overall strength in financial management. From a buyer's perspective, the amount of working capital an agency needs has a dollar-for-dollar impact on its value—and the need for working capital varies directly with the effectiveness of an agency's collection procedures.

If an agency is a poor collector, a buyer either will be forced to put capital into the business or use more of the agency's operating cash to cover accounts-current payments. Poor collections also have an impact on profitability, as less premium float is available to generate investment income. Without considering the effect that poor collections has on bad debts, an agency's inability to bring in the money it is owed on a timely basis can reduce value by as much as 29.6% (see chart on p. 10). In an agency with rev-

Impact of Collections on Agency Value

Hypothetical Pro-Forma Valuation	
Pro-Forma Revenues	1,600,000
Pro-Forma Expenses	1,248,000
Pro-Forma Pre-Tax Profit (Assumed 22% of Revenues)	352,000
Hypothetical Value of the Customer List (5 Times Profit)	1,760,000
Plus: Tangible Net Worth (12% of Revenue)	192,000
Hypothetical Fair Market Value*	1,952,000
Impact of a Buyer's Working Capital Requirement	
If Seller Has Been a Poor Collector	
- 120 Days of Expenses and Taxes	456,600
Less: Had Seller Been a Great Collector	
- 30 Days of Expenses and Taxes	114,100
Impact on Agency Value	342,500
Impact on Agency Value as % of Agency Value	17.5%
Impact of Investment Earnings on Value	
Great Collector - Additional Investment Income**	23,100
Plus: Poor Collector - Investment Income Not Received***	24,000
Impact on Pro Forma Pre-Tax Profit	47,100
Impact on The Value of the Customer List (5 Times Profit)	235,500
Impact on Agency Value as % of Agency Value	12.1%
Total Impact On Agency Value, In Dollars	578,000
Impact on Agency Value as % of Agency Value	29.6%

* Assumes Average Collector
** Increase In Earnings Relative to Average Collector, at 5% of Premium Float
*** Decrease In Earnings Relative to Average Collector, at 5% of Premium Float

enue of $1.6 million, this can translate to a loss in value of almost $600,000.

Producer vesting

In the past few years, it has become increasingly fashionable to use producer vesting as a tool for securing noncompete or nonsolicitation agreements and as an incentive for new-business production. But few decisions made by an agency manager have as negative an impact on agency value as a decision to implement producer vesting.

The typical producer contract with a vesting component has a termination provision granting a departing producer an option to purchase the agency's ownership in his or her book of business. If a producer exercises that option, the agency's profitability will suffer dramatically. The agency's infrastructure is designed to support a large volume of revenue and therefore includes many fixed costs. The agency will receive payment for the departing producer's book and obtain some cost savings. But these financial benefits seldom are enough to offset the significant decline in value resulting from the agency's increase in overhead as a percentage of revenue.

A buyer reviewing an agency whose producers are vested will seek to negotiate new contracts with them to protect the business and enhance the reliability of the agency's earnings stream. The buyer will do this before negotiating with the agency's principals. Whatever value remains after the producers' books of business are secured will be allocated to the agency's value. If the producers have an inflated opinion of the value of their books of business or need to be encouraged monetarily to accept new contracts, the owners' value will suffer. Producers' refusal to sign new contracts will significantly lower the agency's value or kill the deal outright.

Producer vesting also typically fails as an incentive for new-business production. Producers with vested ownership in their renewals seldom generate sizable books of business. They tend to consider themselves free agents, are overly protective of their books and therefore are unlikely to take full advantage of the agency's staff. Lack of delegation causes their books to be comprised of small accounts. Growth is stifled, because the need to service the labor-intensive small accounts reduces the time available for new-business production. Also, the agency's profitability tends to suffer, as these producers have little incentive to write profitable business or channel premium to companies in a way that maximizes contingent income.

Provided that it has a high-quality production staff, an agency should consider converting the ownership producers have in their renewals to agency stock. As shareholders, the producers will have an incentive to use the staff to the fullest extent and write business that is profitable for the agency's carriers. They also will be more likely to act as team players, since they will participate in any distribution of profit and in any growth of the agency's value. The cohesiveness of the agency will increase in the eyes of a buyer, and the producers' ownership status will validate their importance to the organization.

Providing stock ownership dilutes an individual producer's negotiating leverage. More important, shareholder agreements tend to be much more enforceable than producer contracts because all shareholders receive proceeds in the sale; therefore, a buyer will have more confidence in the purchase agreement's noncompete and nonsolicitation provisions and in the likelihood that a high percentage of the acquired business will be retained.

Unfortunately, when an agency determines that it cannot perpetuate ownership internally, it often is too late—too late to establish a plan to perpetuate ownership and too late to plan appropriately for a sale.

In this column, we have identified two of the many steps one can take to maximize agency value. These steps are worth taking whether you are committed to perpetuation or a sale.

John M. Wepler is a vice president and shareholder at Marsh, Berry & Company Inc., a national consulting firm that deals exclusively with independent insurance agencies, brokers and banks. Services include merger and acquisition consulting and intermediation; ownership perpetuation planning; incentive compensation planning; agency fair market valuations; operational consulting; and loan acquisition, facilitation and determination. Correspondence may be addressed to John M. Wepler at 7466 Auburn Road, Concord, Ohio 44077. Mr. Wepler's telephone number is 800-426-2774. His e-mail address is John@marshberry.com.

For The Manager

John M. Wepler

When divesting, prepare to maximize value–Part II

LAST MONTH'S column described a common dilemma faced by many agency managers committed to perpetuation: Producers, employees and minority shareholders often promote themselves as interested buyers, yet turn out to be too risk-averse to actually sign a perpetuation note. Insurance agencies in this situation have two alternatives: merge with, or sell to, another entity.

Few agencies recognize the importance of planning to improve performance prior to pursuing such a transaction. Once committed to a merger or a sale, an agency should identify and improve those areas that will have the largest impact on value. Two of the many critical areas, collections and producer equity, were addressed in last month's column. This column will address agency cost effectiveness, another area than can be improved to enhance agency value.

Cost effectiveness

An agency's cost effectiveness is determined by reviewing servicing costs, which are comprised of customer service payroll and operating expenses. (For definitions of these terms, please see the note at the end of this column.)

A recent Marsh, Berry & Co. study illustrates the effect cost effectiveness can have on agency value. In the study, we compared the statistics of two groups of agencies: those with a selling price in excess of 1.5 times revenue (the high-value group) and those with a selling price less than 1 times revenue (the low-value group). The low-value group had costs (expressed as a percentage of commissions and fees) of 19.5% for customer service payroll and 24.6% for operating expenses, for a total of 44.1% in servicing costs. The corresponding figures for the agencies in the high-value group were 14.1%, 16.9% and 31%. The 13.1-point spread (44.1% minus 31%) in servicing costs between the two groups is a major factor in the difference in their value, as performance relates directly to bottom-line profitability.

Operating expenses

High-value agencies have the coveted ability to contain operating expenses at a very favorable level. These agencies budget expenses closely and have perfected the talent of managing their costs. While penny pinching is a trait practiced by many of the high-performing agencies, most recognize that agency growth is a far more effective tool for managing overhead. Agencies within the high-value group attained revenue growth in excess of 9%, compared with revenue growth of 2.5% in the low-value group.

As a general rule, operating expenses tend to track with inflation. Agencies that can achieve growth in excess of inflation reap the rewards of economies of scale (lower operating expenses, as a percentage of revenue). Profitability stemming from agency growth results in enhanced agency value.

Chart I - CSR Productivity Statistics

Personal Lines	Avg. Acct. Size $100 (com.)	Avg. Acct. Size $280 (com.)
Avg. No. of Accts. Per CSR	790	410
Avg. Commission Per CSR	$78,966	$114,870
Best 25%, No. of Accts. Per CSR	1,046	600
Best 25%, Commission Per CSR	$104,591	$167,901

Commercial Lines	Avg. Acct. Size $1,350 (com.)	Avg. Acct. Size $3,900 (com.)
Avg. No. of Accts. Per CSR	127	59
Avg. Commission Per CSR	$171,625	$228,306
Best 25%, No. of Accts. Per CSR	181	92
Best 25%, Commission Per CSR	$244,539	$357,625

Customer-service payroll

The total customer-service payroll, expressed as a percentage of commission and fee income, is much less than average in high-value agencies. Payroll per customer service representative is above average, but these agencies have a comparatively small servicing staff. High-value agencies proactively manage servicing staff workload and pay handsomely for superior performance.

The volume of business that can be handled by a servicing staff varies with the size of an agency's accounts. Chart I illustrates how account size influences servicing staff productivity. The table provides benchmarks for average performance and for the best 25% in the industry. (The table does not, however, relate directly to the aforementioned study of high-value and low-value agencies.)

Clearly, the size of the accounts that can be written by an agency depends on the rates in its area and the nature of the accounts available. But regardless of such factors, an agency should make a concerted effort to increase the size of its accounts.

An agency also should strive to develop a productive servicing staff, compared with agencies having accounts of similar size. Most high-value agencies monitor the number of accounts each member of the servicing staff handles and the total commission income those accounts represent. Quite often, a high-value agency has a formal incentive plan outlining expected levels of performance and providing additional compensation to CSRs who achieve their goals.

One particularly effective technique is to establish a bonus plan for CSRs. An agency should establish goals and objectives in critical areas and communicate them to each CSR during the performance review process. At the next review, the agency can award a

bonus to each CSR based on his or her performance.

All of the agencies in the high-value group had a different approach to managing the servicing staff and encouraging it to perform at a high level. Chart II presents a worksheet we feel most agencies can use to promote high customer-service performance. Each of the four categories designated on the worksheet should be weighted according to an agency's overall objectives. The following comments provide guidance for using the worksheet:

Retention: The retention calculation is based on the number of accounts a CSR retains for a full year. New accounts assigned throughout the year should not be included in this figure.

Leadership/agency results: Each CSR should be asked to track any special projects in which he or she participates during the year that support the agency's objectives. CSR performance in these projects should be subjectively evaluated to reward notable accomplishments. The change in the agency's total premium volume should be factored into this part of the incentive plan, because individual leadership success should translate to agency success.

Growth of book handled: An effective incentive plan should take into consideration the total commission-income growth of each CSR's book of business. CSRs should be encouraged to increase commission income by writing new business, rounding out existing accounts and lobbying for new accounts written by the production staff.

Customer service: The agency should ask each producer for the names of five customers handled by each CSR a producer works with. Those insureds should be contacted in person, by telephone or via surveys, to learn of the service they received from the agency.

An incentive compensation plan for the servicing staff can help an agency increase growth, improve employee workload, enhance payroll for deserving employees and reduce overall servicing costs. The result is greater cost effectiveness, which can increase agency value, regardless of whether an agency is committed to perpetuation or to a sale or merger involving a third party.

[**Note:** As the term has been used in this article, *service payroll* refers to payroll and bonuses for all personnel directly engaged in the servicing of customers, excluding producers and sup-

(Continued on page 69)

Chart II - CSR Bonus Plan

1. Retention; ___% of Available Bonus

A. *Calculation of Performance*

Ending # of Accounts	______________
Less: New Accounts During Year	______________
Equals: Accounts Retained	______________
Divide by: Beginning # of Accounts	______________

B. *Establish Goals*

Retention Goal	Bonus %
98% or better	100%
94% or better	75%
90% or better	50%
Less than 90%	0%

2. Leadership/Agency Results; ___% of Available Bonus

A. *Leadership Rating*

Cite contributions to the agency during the year, educational presentations, special projects, etc. (Rating of 1-10)

Rating	Bonus%
10	100%
9	75%
8	50%
Less than 8	0%

B. *Agency Results*

Increase in Prem. Volume	Bonus %
15% or more	100%
10% to 14.99%	75%
0% to 9.99%	50%
less than 0	0%

3. Growth of Book Handled; ___% of Available Bonus

Increase in Commissions	Bonus%
+10%	100%
+5% to 9.9%	75%
+2% to 4.9%	50%
less than 2%	0%

4. Customer Service; ___% of Available Bonus

Overall satisfaction of customers (Rated from 1 to 10)

Average Rating	Bonus %
10	100%
9	75%
8	50%
less than 8	0%

FOR THE MANAGER
(Continued from page 19)

port personnel. Included are claims people, marketers, customer service representatives, account handlers, account secretaries, underwriters, placers, technical support personnel and raters. Managers of personal-lines and commercial-lines service personnel, risk management consultants, loss prevention engineers, adjusters and attorneys also would be included.

Operating expenses refer to facility expenses (rent, utilities, property maintenance, real-estate property taxes), telephone (local and long-distance telephone charges and maintenance costs on purchased phone systems), postage (freight, special delivery charges, telegrams), office supplies and printing (stationery, pens, pencils, special printing charges, business cards), subscriptions (all magazines, reader services, special report costs, journals, newspapers), dues (associations, business groups, clubs), charitable contributions, taxes (local taxes, personal property taxes, franchise tax on assets or sales, but not federal tax liabilities), licenses, insurance costs (property-casualty insurance costs including E&O insurance, but not employee benefits insurance or the cost of officers' life insurance), professional fees (legal, accounting and consulting fees), equipment rental and maintenance (machine leases and service contracts, office equipment, postage meters, repair and maintenance, leased phone systems), bad debts (including claims losses and any amounts advanced that are not collectible) and outside services (computer service, MVRs, rating services, bookkeeping, secretarial, cleaning, janitorial, collections, temporary services).]

John M. Wepler is a vice president and shareholder at Marsh, Berry & Company Inc., a national consulting firm that deals exclusively with independent insurance agencies, brokers and banks. Services include merger and acquisition consulting and intermediation; ownership perpetuation planning; incentive compensation planning; agency fair market valuations; operational consulting; and loan acquisition, facilitation and determination. Correspondence may be addressed to John M. Wepler at 7466 Auburn Road, Concord, Ohio 44077. Mr. Wepler's telephone number is 800-426-2774. His e-mail address is John@marshberry.com.