

# Sitting on the Fence Is Not an Option

*Straight Talk with John Wepler of MarshBerry*

**N**othing looks like it did just less than a year ago. Insurance companies have low or negative investment returns, there is an acute shortage of capital, the macro-economic outlook is dismal, there is volatility in investment and underwriting performance, and the prospect of tougher regulation exists at all levels. This is the changing landscape our industry is traversing in as we move forward and look for ways to thrive and grow in a climate that for some is raining havoc.

To help us sift through today's challenges and look at what's available for programbusiness.com members, we spoke with John M. Wepler, president of Marsh Berry and Company. Marsh Berry is a management consulting firm and a merger & acquisition advisory firm that works exclusively with retail agencies, wholesale brokers, program managers and managing general agencies. The firm has more than 900 consulting clients throughout the United States and has been ranked the nation's number one merger & acquisition deal advisor for the past 9 years having brokered over 555 acquisition or divestiture transactions since the firm's inception.

"We have a tough mountain to climb", says John. "But doing nothing is not an option, not if you want to preserve or enhance the value of your business. There are rays of hope shining through this mess but it requires a commitment for change and the fortitude to execute."



The "mountain" that John refers to consists of several external forces, including increasing pressure from insurance companies to perform, disintegrating financial metrics, a changing M&A market, an increase in the capital gains rate, the threat of some kind of national health care, a continuing credit crisis and an overall decline in agency value. "Rates are starting to level off in certain segments and it appears that the market will soon start to show signs of hardening. But, the potential improvement in rates will not be able to offset the hit to the insurable risk base. Simply put, net growth for most will be flat or negative during 2009," says John. "There is no hope that during 2009 rate growth will be sufficient

to offset the contraction in business income and payroll for most agencies. Most commercial businesses are in defense mode, are flat or shrinking and growth in the risk base is retrenching. Activities such as building a new plant, hiring additional employees or expanding a truck fleet have ceased for most commercial insureds." Insurers will soon need to pursue rate increases given a hit to surplus, poor investment returns and underwriting losses. But the demand for insurance during the recession will continue to fall due to risk compression and as insureds look for ways to cut costs through higher retentions, negotiating fees in lieu of commission or going bare. This will impact the entire distribution system, from growth through profit to valuation.

Furthermore, declining asset values, a significant downturn in the equity markets, and a lack of capital availability is shaking up how the industry views mergers and acquisitions, and is impacting the type of deals that are being consummated. Before there was an abundance of capital, a slew of buyers and a limited supply of sellers. Today, the reverse is occurring, making it increasingly difficult for mergers and buy-outs to occur.

So what is one to do? John says there are basically three options:

1. *Do nothing and allow value to dissipate*
2. *Embrace and execute change to drive performance and to control the future*
3. *Sell*

### **Program Management/Managing General Agents, Benefits Retailers and Small P&C Retailers**

Did we say sell? In program management, MGA, retail benefits and the small P&C agency space, many already have and countless are in process. "There is a robust and renewed appetite among buyers in this segment if the target has the right business profile," says John. "Most of the active buyers of retail agencies are overly dependent on property and casualty (P&C), which has experienced less rate growth than the benefits area. In addition, the P&C segment has faced so many years of softening that service requirements now yield low margins relative to benefits counterparts. Acquiring retail benefits can prop up the short-term profit and organic growth of the traditional buyers while providing wallet share and retention opportunities. Buyers have their spigot wide open to catch benefits retailers while those same benefits retailers are lining up to capture value for fear that the administration and President Obama may legislate their demise. Remember, investors act on greed and fear. Regardless of what will happen, many agency owners (just like investors in general) are acting on that fear right now. Small P&C retailers that can be folded in to another office of a buyer are in high demand as well, given the immediate profit leverage that can be achieved through consolidation of employees and infrastructure."

"Program Managers and MGAs with niche sophistication, underwriting specialties, unique claims insight and a value-added platform are in a unique position, as there is heightened buyer demand in this area by insurance companies, brokerage firms and larger regional private firms." Those with a defined tangible expertise that understand a specific market niche or have the power of the underwriting pen coupled with claims expertise are in high demand by every buyer segment. These firms

are not only poised to expand underwriting profitability but have imbedded growth potential in this challenging market. "The existence of intellectual property that can be further leveraged to drive growth and profit are the acute focus of acquirers," says John. For example, carriers are looking to prop up poor earnings, stale premium growth and reduced surplus by acquiring and expanding boutique firms that drive predictable premium and profitably. "Those with a specialty and those with underwriting capabilities are in a good position now and buyers are forming a line," says John.

### **Larger Diversified Retailers and Wholesale Brokerage**

While demand may be high for specialty firms and benefits retailers, demand for the remainder of the insurance segment has declined considerably, including large regional diversified retailers and wholesalers with a vanilla value proposition. Value expectations of large diversified retailers remains high and the typical buyer's perspective on value are too much of a mismatch given the cost of capital and the inability to leverage post-closing profit through integration. Sellers are beating their chests and buyers are not returning their calls.

### **The Solution**

Sitting on the fence and doing nothing is not an option, according to John. Those unfortunate segments that are out of favor cannot sit back and allow agency value to dissipate. "Firms in these segments must get serious about organic growth, profitability and pursuing a process to build an internal market for their stock, if they want to secure or drive value," says John. How does one go about doing this exactly? By committing to the creation of an organic growth platform, embracing reinvestment in talented youth and reversing the aging ownership base by relinquishing stock gradually.

The average and best 25% in this segment achieved new business production equivalent to 15.1% and 23.5% of the prior year base, respectively. And this has not happened by accident. The era of talking about sales accountability is old news for most high performers and has been replaced by process-driven accountability that hits the pocketbook of those in production who can't perform. High-performing firms now require participation in pipeline management to get a paycheck and have implemented a carrot and stick compensation plan. Those in production who drive new business below set minimum standards either become displaced, move to a different role, take a pay cut or suffer a reduction in their renewal commission percentage. Those who exceed the minimum and attain stretch goals secure a sizable bonus that continues to crank up at various levels of performance.

Industry leaders, John indicated, are reinvesting heavily in young proven sales talent with no insurance expertise and hold these fiery-eyed scrappers accountable to an activity-based prospecting process coupled with mentorship from the gray-haired technical experts. Hiring experienced expensive talent from competition is practically non-existent in the high performers. Such an approach that has plagued the industry for decades is not only reactive and opportunistic (versus a strategy), but it generally serves to secure retreats and rejects that are skilled at selling themselves into a high guaranteed salary, but are unskilled at conforming to process or moving the needle on new business production. “Thankfully, the era of hiring an elephant hunter that miraculously is looking for a job is now recognized for what it is, an expensive experiment with a low probability of success. That strategy has died for most leading the pack in organic growth,” says John.

Insurance firms in all segments have done a poor job at getting stock in the hands of younger employees. The weighted average owner age in the average firm is 54 (calculated as the sum of each owner’s age times their stock ownership position). The best 25% have brought the weighted average owner age down to 43 years old while the bottom 25% have an average age of 63. “To attract, retain and motivate key stakeholders to grow beyond themselves, enable the business to create the cash flow to cover debt service of retiring shareholders and to teach the next generation perpetuation debt risk tolerance, ownership must be broadened gradually over time,” says John. If that does not occur, retiring owners will not want to hold the paper on their own buy-out given that the risk of default is too high. In fact, if an owner holds greater than 65% of the stock and agrees to sell that position based on a 7-year note at 6% interest with no down payment, the business will produce deficit cash flow in the first year assuming low single-digit organic growth. With

such a metric, sellers generally won’t hold the note and banks, even in the era of wild access to capital, ran for the hills. This often prompts a sale to buyers that inevitably wonder if the other key people were too unimportant or had a personality such that the owner did not think they deserved meaningful ownership participation.

This almost always forces a sale at a lower valuation than if there is broad ownership. Buyers place a great deal of confidence in the strength and defend-ability of non-compete and non-solicitation agreements when all of the key people are receiving proceeds from a sale. In short, firms with the foresight to transfer ownership over time to high-performing individuals who are driving value are more likely to perpetuate, and if and when they choose to sell, will realize a higher market value than agencies with narrowly held ownership. As illustrated in the chart below, owners who desire to keep their talons in the stock are also worth less in an internal and external sale because organic growth is less sustainable.

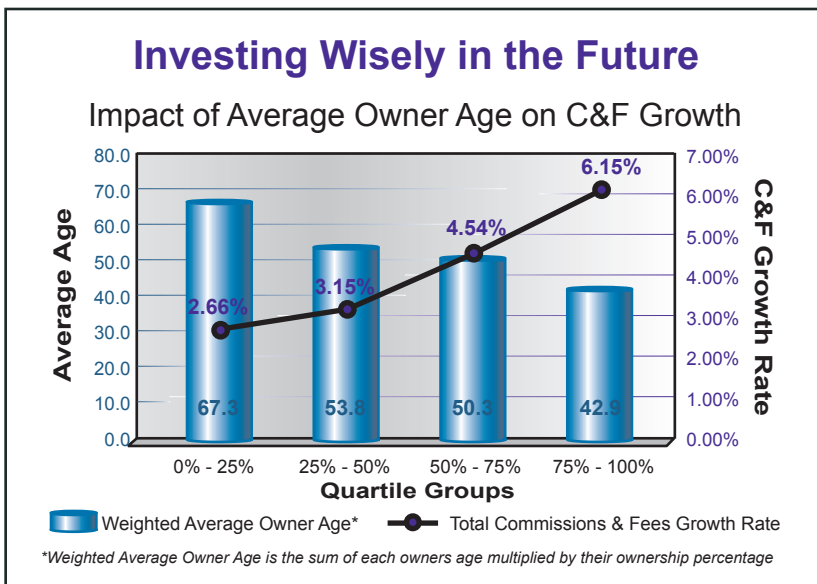
While times are challenging, there remains no better time to be in the insurance business, reaffirms John. History has proven to us once again what we have always known...“the insurance business is the best-kept secret in commercial business today”. We have also been reminded of another tidbit that continues to prove sacred “It is better to be on Main Street than Wall Street”. “While insurance may not be sexy, it drives considerable wealth and frankly, we all should be nightly paying homage to renewal income, which is a foreign word in many other industries,” says John. “If you want to hold or fold today or tomorrow, committing to and executing a plan that secures talent and drives performance translates to value. And, it is probably the only asset you own that you have any hope of controlling. There are tremendous opportunities for those who are ready to make the investments needed to move forward, whether it’s developing or expanding a unique niche, specialty or underwriting capability, or committing to embracing change that will drive predictable growth and value.”



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MarshBerry’s deal advisor ranking is provided on the back cover of this publication.

For additional information regarding MarshBerry’s services, please visit us at: [www.MarshBerry.com](http://www.MarshBerry.com).



## SNL Financial M&A Advisor Rankings

Insurance Merger & Acquisition Deals  
1999-2008

Rank	Firm	1999 - 2008 # of Deals	2008 # of Deals
<b>1</b>	<b>Marsh Berry &amp; Co. Inc.</b>	<b>248</b>	<b>31</b>
2	Hales & Co. Inc.	116	29
3	Reagan Consulting Inc.	114	18
4	Mystic Capital Advisors Group LLC	86	16
5	Fox-Pitt Kelton Cochran Caronia Waller	83	6
6	Goldman Sachs & Co.	79	1
7	Credit Suisse (USA) Inc.	55	2
8	Merrill Lynch & Co. Inc.	51	0
9	Philo Smith & Co.	42	2
10	Keefe Bruyette & Woods Inc.	38	2
11	Banc of America Securities LLC	37	5
11	Morgan Stanley	37	0
13	Citigroup Global Markets Inc.	35	2
14	J.P. Morgan Securities Inc.	32	0
15	Merger & Acquisition Services Inc.	30	0
16	Lazard Freres & Co. LLC	23	0
17	UBS Investment Bank	20	0
18	Bear Stearns & Co. Inc.	18	0
18	Lehman Brothers Inc.	18	0
20	Sandler O'Neill & Partners L.P.	17	3
21	Harbor Capital Advisors Inc.	14	0
22	Sica Consultants Inc.	13	0
23	North Bridge Advisors Inc.	12	0
23	Prisco Consulting Inc.	12	0
25	Wachovia Securities LLC	11	0
26	Gill and Roeser Holdings Inc.	9	1
26	Curtis Financial Group LLC	9	0
26	Houlihan Lokey Howard & Zukin Inc.	9	0
29	Raymond James & Associates Inc.	8	0
30	Nexus Group Inc.	7	0

All States // Completed/Pending/Term Transactions  
Whole and Asset deals as reported by SNL Financial, January 2009

### #1 Insurance Information Resource

Proprietary benchmark statistics on over \$4.5 billion of aggregate brokerage revenue. Used by brokers, insurance carriers, financial institutions, private equity firms and others.

### #1 Insurance Management Consulting Firm

Sales management, operational, and financial consulting services to 57 of the Top 100 Brokers and numerous financial institutions.

### #1 Insurance Exchange Networks

Own and operate 3 best practices exchange networks comprised of over 175 agencies and brokers representing more than \$3 billion in aggregate revenue and \$27 billion in premium.

### #1 Insurance M&A Advisory Firm

- Over 230 transactions with Top 100 Brokers
- 140 Bank Insurance transactions
- Over 550 transactions closed
- Ranked #1 by SNL for the past decade

