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Preparing a Game Plan for Insurance Agency Acquisitions, by Allen Go

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Gaming the System?

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"When one door closes another opens, and we often look so long and regretfully upon the closed door that we do not see the one which has opened for us."

-Alexander Graham Bell

It's time for a Fresh Approach. It's time to TAP into More Profits.

Sell Protection: Professional agents do not sell insurance. They protect their clients' assets. Insurance is simply the most common means for providing

(Note: This was written prior to Hurricanes Harvey and Irma.)

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that protection. Imagine you were selling fertilizer. A person buying fertilizer does not want fertilizer. They want a green lawn and healthier crops. The fertilizer is simply the means to the end just like insurance is the means to the end for protecting your clients' assets. The catch is to make "protecting assets" as tangible as a green lawn and healthy crops.

Assign Costs: Cost is obviously important to customers. Cost is also tangible. So turn cost around and make it work in your favor. Help your clients realize insurance is only one part of the big picture and the big picture is critical to their financial security. Show them the whole picture is much more than the policy premium.

Learn how to show your clients how you will provide Total Asset Protection while saving them money. The result? Better protection for your clients and more profits for you.

Contact Burand & Associates today to learn how to TAP into More Profits!

Is your agency making calls or taking calls?

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Otherwise, the act of quoting and selling is purely reactive when answering a phone call. The best prospects do not shop for insurance by dialing up lots of agents. Instead, proactive agents solicit the best prospects. It is like anything that is attractive. People go to the attraction. The attraction does not go to the people!

Reactive selling, taking calls, is an adverse selection process 99% of the time. Even in servicing an account, agents have a choice between proactive servicing and reactive servicing. For example, quoting requested coverages is the epitome of reactive sales and service. Even if quoting existing coverages is done with a great big smile, reactive sales and service is not worth much. A computer bot can now do it as well, often better and cheaper than a human. The reactive CSR/Producer quoting existing coverage does not have much of a future. Worried about computers replacing humans? These folks, the reactive ones, could be the insurance casualties. If this is your business plan, reactive sales/service, you might want to retire now.

One example of proactive service is using a coverage checklist, learning about your client's situation and risk needs, providing them coverages that fit their exact needs versus vying to write as requested, i.e., inadequate coverages at the lowest price. This is, after all, exactly what thousands of CSRs and producers do every single day. Instead, write accounts proactively and correctly.

Another test of whether your agency is making or taking calls is your cross-sell ratio. A low ratio (industry average is approximately 1.7 policies per account for independent agencies) almost guarantees the agency is reactive -- even passive.

Making is more fun and prosperous than taking. If you think this sentiment is nuts, then maybe you are in the wrong business. If the idea of making calls and selling makes you uncomfortable, your anxiety is suggesting a different career path would benefit you. I am not suggesting calls are easy, nor that anxiety is not involved. However, making calls that result in people gaining the coverage, knowledge, and ability to protect themselves and in the event of a catastrophe, be restored financially, should be more than enough incentive to overcome any normal anxiety for a person that belongs in this industry. Furthermore, to be paid to do such an important job should be even more than enough incentive.

Obviously these wonderful facts are inadequate motivators or the industry would have many more makers than takers. Are you a maker of calls? Are you a maker of good coverages for your clients? Or are you and your agency takers? Makers contribute. Takers take. Which do you aspire to be?

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Why are you looking to buy agencies?
If your answer is because everyone else is doing it, someone may have to ask you that if everyone were jumping off a bridge, would you do that as well? While acquisitions are a means to achieve above average growth, there are agencies who have done quite well just focusing and relying on organic growth. There are many potential problems that can also occur after an acquisition has been completed. Some of these could include time and energy spent on a fumbled integration process, producers and clients leaving, employees worried about their future at the combined firms, infighting from the merging of two potentially different cultures, and other unforeseen issues. If that hasn't scared you yet or you are prepared to take on these potential challenges, read on.

Why are you really looking to buy agencies?
There are several reasons agencies pursue acquisitions:

- To gain size and scale to better compete with larger brokers and have more volume with carrier partners
- To expand to different locations within a geographic area
- To add to or enhance certain lines of business
- To bring in additional talent in the form of partners, producers, and employees
- To be able to share knowledge and best practices in order to obtain additional synergies above and beyond the normal combination of two firms

Identifying the criteria in an ideal acquisition prospect helps crystallize which agencies one should be targeting for acquisition. Some of these include the following:

- Geographic location -- Are you mainly looking to buy within a close distance to your existing office to allow for easier integration of the acquired book of business and employees? If the agency is further away, are you or your management team willing to travel to and be involved in the operation of the acquired agency? Identify a radius that you are comfortable with such as within a 10, 25, or 50-mile radius of your office. If your goal is expansion, identify the cities or metropolitan areas that are ideal locations.
- Size -- How large of an agency in terms of revenue and employees are you looking to purchase? The size of your own agency plays a role in how easily an acquired agency can be integrated. A $10 million revenue agency can more easily integrate a $2 million revenue agency compared to a $1 million revenue agency trying to do the same thing. It also depends on your management team's manpower as an acquisition is similar to a mass hiring situation. Can you and your team onboard 5, 10, or 20 people all at once without it affecting the quality of your own business?
- Lines of business -- Are you looking to acquire an agency focused on commercial P&C, benefits, personal lines, or a combination of all three? If you have an agency focused on one, are you comfortable expanding to another line of business or do you need someone to spearhead and manage it?
- Owner involvement post-transaction -- What would your ideal situation be as far as the selling owner's responsibilities after the deal closes? Some owners want to sell their book of business and leave shortly thereafter. Others are willing to stay on for a 2 or 3-year transition period before retiring or leaving. And still some others are looking to remain active for a longer period of time and don't have any plans for retirement. When talking to a potential seller, it is advisable to ask what their short and long-term plans are so that you can filter out those situations that may not be a fit.

After you have a feel for the types of agencies that fit your ideal profile, the next step is to get your finances in order. Whether that be building up a cash war chest or lining up financing, be aware that you are competing with well capitalized acquirers who can easily write a check in the millions of dollars to close a deal. You could inquire with your current banking relationship to see if they are willing to provide funding for an agency purchase. Be aware that some banks may avoid loan situations where there are no tangible assets to serve as collateral. There are some financing institutions that are comfortable making loans to insurance agencies and understand the nuances of the industry. Some of them can be found at this web site: https://www.agencyequity.com/listings/insurance-agency-loans.

In addition, you could also ask your merger and acquisition advisor for any contacts they may have that are particular to this space.

When you are confident that you have the financial resources to pursue a deal, think about what differentiates you from the competition as far as buyers go. Remember that you will be competing with the likes of serial acquirers like Arthur J. Gallagher, Hub International, and Brown & Brown, Acrisure, AssuredPartners, and several others. They can offer additional resources and capabilities, back office and administrative support, and financial backing among other things. Identify what you can offer to a seller that will entice them to join your firm over the others. Reputation in the marketplace is important and could be the deciding factor when all things are equal.

About the Author:
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Gaming the System?

(Note: This was written prior to Hurricanes Harvey and Irma.)

One of the most misunderstood quality symbols in the insurance industry is a rating company's rating. Over time, people within the industry, everyone from CSRs to, I suspect, some regulators, have come to believe such ratings stand for much more than what the rating companies mean. Because a rating is important mostly only when something goes terribly wrong, an extensive misunderstanding of what a rating means likely does not matter 98% of the time. But the 2% of the time when it matters, usually when a disaster or insolvency occurs, the damage can be severe.

A.M. Best is the best known insurance company rating firm and I think it is also the oldest. Their claims paying notice/disclaimer states:

"Best's Financial Strength Rating (FSR) is an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations." ***Understanding Best's Credit Ratings*****, July 28, 2017, p. 17.**

The rating is about paying claims. Their ratings are not about operational stability. These are two quite different, sometimes related and sometimes not related, issues. The difference is why a run-off company can have a high rating (which is crucial in this situation) but not actually be operational. Yet, this is also why a company that is clearly deteriorating can have a high rating, if they have adequate surplus of an adequate quality. (Not all surplus is created equal which is an important point many agents and some company executives I've known do not understand).

I regularly analyze insurance company financials using the carriers' filings. Maybe it is a coincidence or maybe times are changing. Either way, some companies have maybe recognized the weakness such extreme focus on claims paying rating creates. That weakness seems to create an opportunity for companies to maintain their rating while making their companies less operationally stable.

A good example I recently reviewed was a carrier that has consistently lost premiums year after year. The company is marginally profitable, at best, and yet its surplus keeps decreasing proportionate to its declining premiums. Its leverage ratios therefore remain relatively steady and this is a key reason I suspect it qualifies to maintain its ratings. However, when a company pays its shareholders good dividends while it is, basically, in de facto in runoff (how else would someone describe a 40% loss of premiums), how do consumers and agencies benefit? If people look at the ratings, do they see an indication of a stronger company than actually exists or do they see a company losing a lot of clients every year, either purposefully or because it cannot compete? Why buy insurance from a company that cannot compete?

Another example that I find few agents know about concerns surplus notes. These are loans against surplus. The normal response I get from agents when they learn a carrier has surplus notes is, "What! How is that allowed?"

Intuitively they understand that a company so poor that it can only use its surplus as collateral has issues. If that company goes insolvent and cannot pay surplus note holders and its claims, while policyholders most likely take precedence, agents do not want to be left holding the bag while attorneys fight it out in court.

Maybe a more nefarious example is how some newer companies are designed like investment funds. The shareholders are effectively paid a percentage of premiums off the top, just like hedge fund managers being paid a percentage of investments without regard to their performance. Such a compensation system makes no sense in the insurance world, at least not to me. To pay a de facto dividend based on premiums written, not even necessarily premiums earned, before surplus is added and without regard for profit is great work if you can get it. However, it has the potential to leave the public, agents, and possibly guaranty funds at risk.

Maybe regulators could look at clawback requirements for innovative stockholder enrichment plans. Maybe if a company underprices to grow quickly, simultaneously pays upfront dividends and goes insolvent, more scrutiny needs to be applied. These are not traditional insurance company models and they haven't been tested in a real catastrophe. I am all for financial innovation but taking money prior to building surplus, finding surplus in unique places and/or building surplus with lesser quality surplus just does not seem to warrant the same stability as a carrier that has $X billion in the bank ready to pay at a moment's notice.

At the same time, some quite traditionally minded carriers that do have considerable high quality surplus are not being valued by agents or consumers for their strength. The ratings are too similar or even identical in some cases. I am not questioning the integrity of the rating companies. I am challenging the communication of the differences because to a common person, a company growing reasonably well with a lot of high quality surplus that only pays dividends/bonuses after profit and surplus additions, especially one with an extraordinarily good capital adequacy score, truly does deserve more quality attention.

On the other hand, a fast growing company (fast growth is a leading cause of insolvency) that pays key shareholders off the top, maybe underprices/under reserves, and with marginal high quality capital and/or less surplus, may need a distinctly different recognition.

Public trust is too important to the industry. At this point, other than ACA insolvencies, insolvencies and downgrades are extremely low so none of this may matter today. Frequency of problems is not the issue. Severity is the issue. Might it make sense to be sure some companies have not been able to rig the system and address this before a catastrophe or black swan event or just time catches up?

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Why were commissions higher in the past?
What will they be in the future?

Independent insurance agency and carrier relationships are a fascinatingly perfect upper level economic class subject. The relationship is a perfect subject because of the economic reality involving the purpose of a company (not specifically insurance companies but companies in general) and it provides a great study for Ronald Coase's Nobel Prize winning economic theory. Mr. Coase first stated his theory in 1932 on why companies exist in developed economies. Vitally important, he explained why companies create efficiencies within an economy (not just why companies create economies for themselves).

Why is Ronald Coase's 1932 economic theory crucially important to understanding the relationship between insurance companies and agents? His theory provides an explanation of the progression of commission rates and the ownership of expirations. Historic and future commission rates are set based quite closely on his theory even though almost no one at any carrier or agency has any idea the theory exists. The reality is that Adam Smith's Invisible Hand makes reality happen per the theory even though the decision makers do not know the theory. Hopefully, with this article, readers will become cognizant of Mr. Coase's theory and by being knowledgeable, will use it to their benefit. Otherwise, as with all economic factors not proactively managed, agents will just be along for a ride, and it will be a tough ride.

Mr. Coase's theory, at its most basic level, is that if a company (not specific to insurance companies) can create an efficiency, it will grow. If a company depends on a vendor, then it will pay the vendor more the more efficient the vendor. In 1986, two other economists built onto Mr. Coase's theory regarding the trade-off between the two parties. In particular, the tradeoff that exists between contracting work to third parties versus keeping work in-house. They specifically used insurance agencies to prove their point. I think they were too far ahead of their time using agents, but now their explanation is more relevant than ever.

The scenario is an insurance company uses independent agents to write high quality accounts at a relatively quick pace. The company issues a contingency contract to encourage some combination of superior performance such as low loss ratios, faster growth, and/or higher retention. In theory, the agents work hard to achieve superior performance so they make larger bonuses.

The company has identified that the most economical way to grow their book is by paying third parties (agents) to grow and the agents also get to keep the expiration rights. Eventually though, the company decides it is paying agents too much. Rather than directly upsetting agents by cutting compensation, the company reduces its advertising/marketing spending, training, or underwriting support, raises rates, decreases the quality of their claims services, or some other nefarious means. Moderation is required in healthy companies because they have to walk a fine line of decreasing agency bonuses more than any revenue loss so that their net income increases.

In a weak company though, running off business with high renewal rates and/or tough underwriting not only decreases agency bonuses, but also damages the company. Agents are ALWAYS bewildered when companies do this. "Why would the company do something so stupid? Don't they understand we will move the business or it will move on its own?" are the questions I often hear. A weak company, quite often, benefits by running off even good business. These firms are often in far worse financial situations than anyone wants to recognize/admit including regulators so this is the company's stealth solution.

Let's assume the carrier is healthy. Then it has to try to balance its goals with agency compensation which, because a perfect solution is only ever momentarily perfect, is constantly changing. This is one reason companies change their contracts (although once in a while someone changes the contract to just justify their job). The net is that companies' and agents' goals can never be perfectly aligned. If both gain more value than the frictional cost, the relationship will continue though. One party will likely benefit more than the other, but both benefit.

The economists also identified that the party who brings the most value to the relationship most likely will own the key asset, i.e. expiration rights. Historically, agents have owned expiration rights. The agent was key to profitability, growth, retention and even reputation.

This standard though applies differently to new and renewal business. For example, life commissions are incredibly high on new business and minimal on renewals because the agent is crucial for putting accounts on but almost meaningless for renewals. The agent's lack of importance at renewal is also why life books are worth so much less than P&C books when sold.

The key to the future of commissions and expiration rights then depends on whether companies can find a way to internally get and keep profitable business more cost effectively than by using agents. Where some agents definitely already see this problem, if they have read their company contracts -- which is a big IF, is with some large group benefit carriers. Because the ACA has contributed to the elimination of many health carriers and so many of the carriers created by the ACA to maintain competition but who did not have to meet standard surplus requirements have become insolvent, the remaining carriers do not need agents nearly as much. The carrier is now far more important to the agent than the agent is to the carrier. Therefore, these carriers have contractually taken over ownership of expirations (I doubt they addressed the gain of this asset properly on their taxes, but that is a different issue). And what is an agent to do about it after the fact?

Some may wonder why the economic theory involved is heralded around the world. I am not doing it justice and I am greatly simplifying the details. Suffice to say, the issue is not simply greed by the company to make more money. Ultimately the issue is diminishing the importance of agents, one way or the other including monopolization of a market, so that the carrier owns the expirations because once they own the expirations, they can much more easily cut commissions.

The key element is minimizing the importance of the agent. This is different than disintermediation or bypassing the agent. This is keeping the agent but minimizing their importance in an effort to make P&C and group benefits more like Life where the agent is only important on the front end. If companies achieve this goal, control of an extremely valuable asset changes hands and renewal commissions decrease precipitously.

Here are some company methods for achieving their goal:

1. Service Centers: If a company does all the renewal work, just how valuable is the agent? Just about ZERO! Contractually the agency owns the expirations and that is all that keeps the agency involved. Contracts can and do change and so do prices. A company might increase prices for accounts in a service center while then offering a deal to the agent or the client: For the agent the deal might be to relinquish expiration rights but keep commissions albeit at lower rates or maybe go straight to the consumer and say, "We [the company] are already doing all the work but you are paying 12% more that we give to the agent for doing nothing. Would you like to save 12%?"

   The company might even be more drastic: turn over the expiration rights if you want to receive any commissions. Either way, agents have limited options if they make heavy use of a company service center. When just a contract and no other business purpose exists, where the agent cannot do the job more efficiently than the company (and judging by what many companies with service centers claim, that their retention actually increases), the contract will be revised. It is just a matter of time. (And in different variations it has already started.)

2. Predictive Modeling: When companies could not efficiently do upfront underwriting, agents obviously provided a valuable service more cost effectively than companies could ever do themselves. Contingency bonuses were well worth the price to companies. For example, one carrier bragged for at least a decade of the large bonuses it paid agents. What they did not say was their profit margin was at least 25% higher than normal as a result so the extra money they paid carried a whale of an ROI.

   With predictive modeling (assuming it works because companies are betting their futures it will), companies do not need agents to do as much and maybe in some lines, NO upfront underwriting will be needed. What then is the value of agents to companies relative to upfront underwriting? How are contingencies affected? Is this possibly why contingency contracts are more often geared toward growth today than historically?

Service centers and predictive modeling are two huge ways in which companies are purposely decreasing the importance of their agents. Both points though still assume, maybe recognize, that consumers see considerable value in agents. However, this reality is under attack too. For example, approximately six carriers spend around $6 billion per year on advertisements and these advertisements are not only about the company, or going direct, but about how agents are completely unnecessary. Some advertisements are subtle and some are in your face about agents being unnecessary. However, at $6 billion per year, every year, for five, ten, fifteen years straight, the effect is like brainwashing. Right, wrong, or indifferent, it has an effect and that is: agents lose their reason to be in the eyes of consumers.

Likely even worse, maybe the worst, is the suicide path so many agencies are taking all on their own. They are not doing the job they are paid to do. In some cases they still think the job is completely about or heavily about upfront underwriting. In these cases, they are misguided but death is still the result. In other cases, agents are just lazy. They are not doing their jobs of selling insurance and in particular, selling the right coverages. They are relinquishing their role in the distribution of insurance. They are relinquishing their value, commissions, and ownership of expiration rights. They are committing slow suicide.

Reality is that companies and consumers do not need to pay full commission for agents that do not work renewals, that do not know their coverages, and that do not work with clients to identify the coverages that match their exposures. Consumers do not need agents that are not advocates at claims time. The agent that does not always grow their book, sell the right coverages, and bring real value to both the client and the carrier is superfluous. It is just going to take time to work through the mechanics. The economic theory is working perfectly and we know the end result per the theory. Agents that allow this to happen will not enjoy nearly the wonderful economic future their predecessors did.

Don't believe this will happen? In benefits, as I already stated, some companies have already drastically changed their contracts. Do you really think P&C carriers are not paying attention to whether agents do anything about it?

The party that brings the most value maintains ownership of the most important asset. In this case, it is expirations and now data at the agency level. What are you, at the agency, going to bring to the relationship that is of such value you get to keep owning your most valuable asset?

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Burand has more than 30 years' experience in the insurance industry. He is a featured speaker across the continent at more than 300 conventions and educational programs. He has written for numerous industry publications including *Insurance Journal*, *American Agent & Broker*, and *National Underwriter*. He also publishes *Burand's Insurance Agency Adviser* for independent insurance agents.

Burand is a member of the Institute of Business Appraisers and NACVA, a department head for the Independent Insurance Agents and Brokers of America's Virtual University, an instructor for Insurance Journal's Academy of Insurance, and a volunteer counselor for the Small Business Administration's SCORE program. Chris Burand is also a Certified Business Appraiser and certified E&O Auditor.

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