

# THE MARSHBERRY LETTER

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## Control Your Destiny

We are starting to see signs of increased commercial lines renewal rates. Is this a precursor of an impending hard market or merely a short-term market anomaly? Only time will tell. The silver lining in the recession was that many organizations were forced to make tough decisions in order to survive. Many of them have made significant progress over the past 3-5 years and now that they persevered, will they have the fortitude to continue to enforce change? The important thing to remember is that there is hard work to be done to sustain your agency and drive growth and value in the long-term, no matter how the market performs. Do not get complacent and reliant on a hard market to drive your growth and profitability. Control your destiny.

## The Market

In the third quarter of 2011, major commercial lines renewed upward across the board for the first time since 2003 – the end of the last hard market (see Figure 1, below). In addition to the increased rate on renewals, we are seeing a shift in some key underlying market fundamentals, indicating that a hardening of the market is likely.

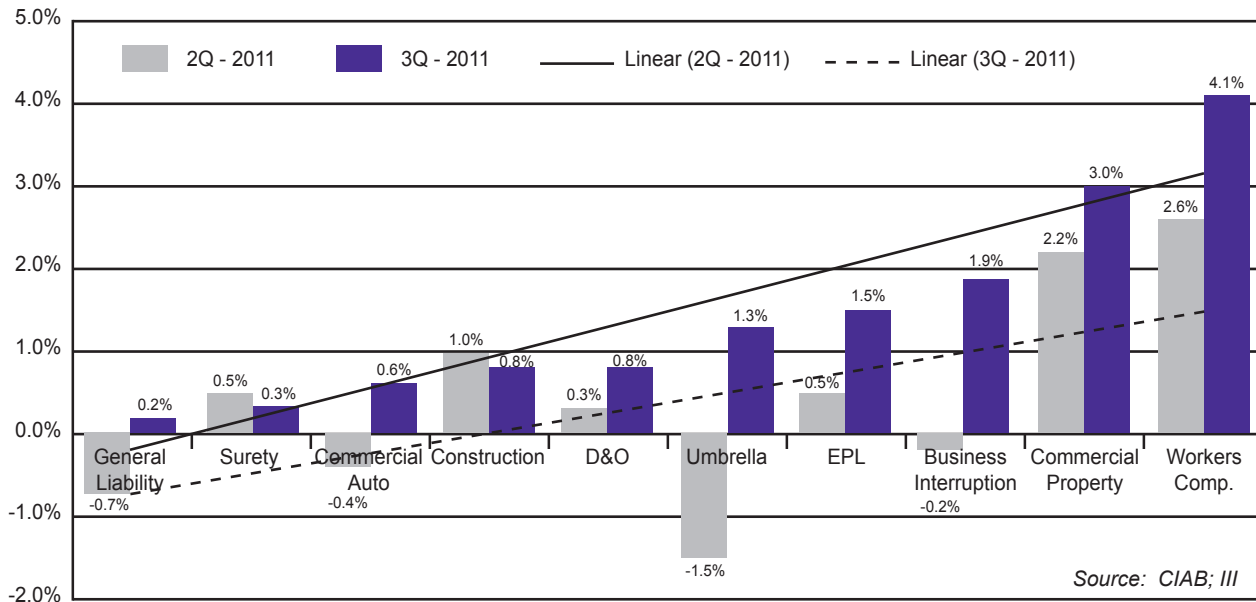
In 2011, underwriting losses will approach \$25 billion, versus just \$3 billion in 2009. Commercial lines underwriting performance will be the worst since 2002. Workers compensation underwriting results will be the worst they have been since 2000. Carriers have been unable to sustain large underwriting losses for long, especially given the volatility of the current investment arena.

After reaching a record high in the first quarter of 2011, surplus capacity has been deteriorating. And, while surplus growth is still outpacing premium growth, hard markets have historically followed periods where surplus growth declined.

An erosion of excess capacity in the market, due to large sustained catastrophic losses, has led to contraction in the global reinsurance market. Reinsurers have been impacted by the recent uptick in cat losses and the pricing at the June 1st renewal time increased, with further expected increases due on the January 1, 2012 renewal.

It is important to note that hard market cycles are not only few and far between, but short-lived as well. In the past forty years, we have witnessed only three hard market

**Figure 1 - Change in Commercial Line Rate Renewals 2Q 2011 vs. 3Q 2011**



cycles: 1975-1978, 1984-1987, and 2000-2003 (see Figure 2, below), each lasting about three years. During these hard market cycles, many agencies rode the easy money wave, as rates, revenues and agency values increased despite the fact that most agencies operated with a “business as usual mentality.”

So, while many market barometers are signaling a market turn and there is a sense of optimism throughout the industry, this confidence should be tempered with a good deal of caution. Agency owners need to focus on controlling what they can control, versus riding the ebbs and flows of the external market. This includes the following:

- ◆ Relying less on contingent payments as a revenue stream
- ◆ A renewed emphasis on agency reinvestment
- ◆ Increasing retention rates
- ◆ Building and maintaining an organic growth engine.

The following sections highlight some of the things successful agencies will do to drive growth and value instead

of waiting for the market to do the work for them.

### Contingent Income

Many agencies have come to rely on contingent payments to bolster earnings and increase owner compensation, while at the same time insulating them from the unpredictability of premium rate growth in the market. For many agencies, contingents account for a substantial portion of top-line revenues and are integral in supporting pre-tax profits and owners’ compensation (see Figure 3, Page 3).

Contingent payments have been decreasing over the past several years and this trend will likely continue given the large amount of cat loss claims that have been filed. The reduction or elimination of contingent income would have a profound personal impact on the average agency owner and in some cases, deliver a crushing blow to the agency’s balance sheet. If this group includes you, you need to ask yourself, “Could you still run your agency and support your lifestyle without contingents?” If not, what steps are you taking to ensure your viability should you lose

all or part of this revenue stream? The less you rely on contingents to make your agency profitable, the better. The best agencies do not need contingents, but rather view them for what they are – bonuses.

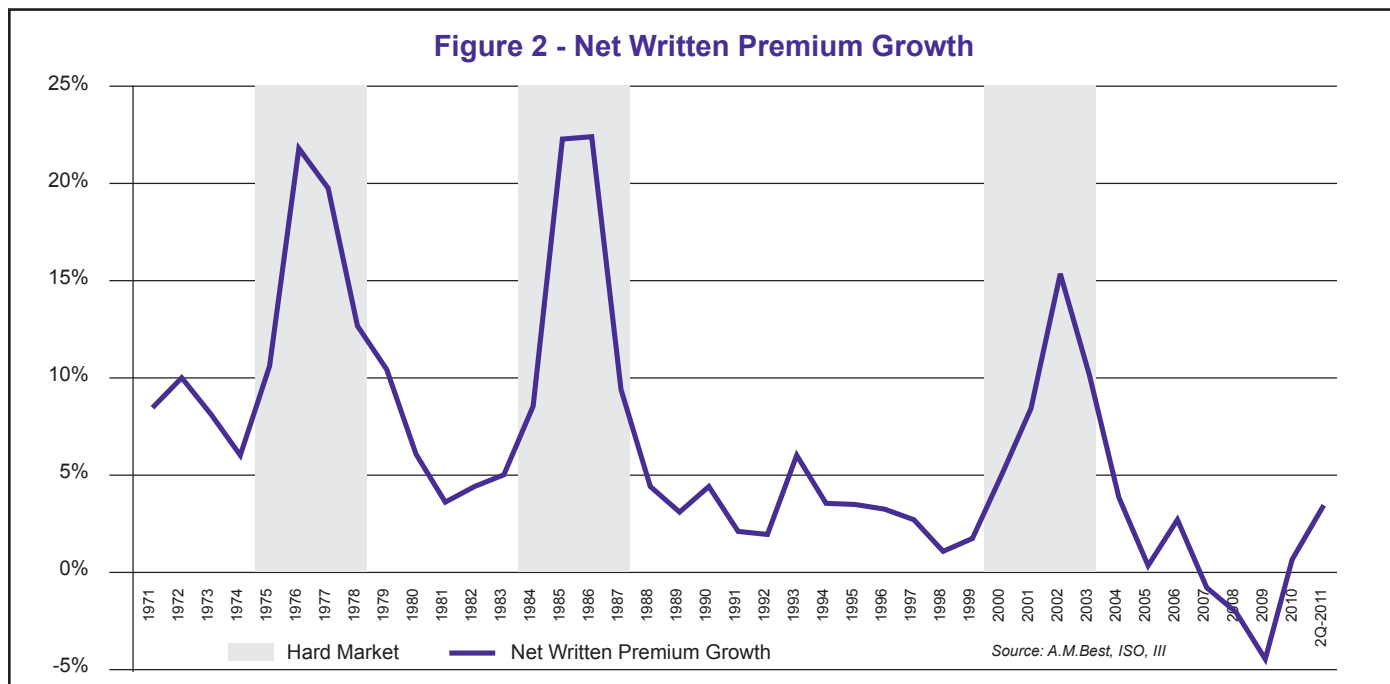
### External Dependency

While it is desirable to maximize outside earnings streams, agencies should not become totally dependent upon those earnings to meet the continuing needs of the agency. The major reason for this is simply that outside earnings are controlled more by outside factors than by agency management.

To determine if the agency is too dependent on outside earnings, it is useful to calculate the external dependency ratio. This ratio measures the relationship of agency profit to non-commission sources. See Figure 4, Page 3 for the ratio calculation formula.

A high external dependency ratio indicates that the agency is relying too heavily on non-commission income to offset poor performance of the actual agency business.

**Figure 2 - Net Written Premium Growth**



<b>Figure 3 - Impact of Contingent Income</b>			
<b>Revenue Size &gt;&gt;</b>	<b>\$3mm</b>	<b>\$5mm</b>	<b>\$8mm</b>
Contingents as % of Gross Revenues	8.9%	7.7%	7.0%
Contingents as % of P&C Commissions	12.4%	11.1%	10.4%

<b>Figure 4 - Measuring External Dependency</b>			
$\text{External Dependency} = \frac{\text{Contingents} + \text{Investment Income}}{\text{Pre-Tax Profit}}$			
<b>Revenue Size &gt;&gt;</b>	<b>\$3mm</b>	<b>\$5mm</b>	<b>\$8mm</b>
External Dependency Ratio	1.22	.91	.96

**Agency Reinvestment**

Whether or not the market hardens, the best run agencies continually reinvest in their personnel and systems. This is certainly easier to accomplish during hard market cycles, where cash is accrued more easily, but given the scarcity and brevity of hard market cycles, agency owners should consider reinvestment no matter how the market is performing.

A useful rule of thumb is to budget for new employee hires. For example, consider building in an investment budget equal to 3% of EBITDA (earnings before interest, taxes, depreciation, and amortization) for the next generation of employees. A continual focus on hiring will ensure that management is being proactive in finding the agency's future producers and leaders. If the EBITDA (and thus value) is too high and there is not a hiring strategy in place, the chances are slim that the organization will be able to perpetuate. A constant focus on hiring, training and retaining quality employees will go a long way to ensure that all options are on the table when the organization considers perpetuation of agency ownership.

If the market does harden and the EBITDA increases in-step, another option is to stockpile cash to help sustain the agency's strategy for when the soft market inevitably returns. Stripping this cash out of the agency might enhance the owner's lifestyle, but will limit the ability of the agency to grow and thrive.

**Increase Retention**

Account retention is the foundation for strong revenue growth. With account retention, the Pareto Principle applies: The top 20% of your accounts typically account for 80% of the agency's revenues. These same percentages normally apply to individual producer books as well. So, core agency account retention focus should remain on the top 20% of the agency's accounts. The best agents and brokers retain approximately 93.2% of their top accounts on an annual basis.

This analysis does not diminish the importance of overall agency retention rates, but acknowledges that some small accounts will normally turn over and the net impact on agency revenue and profitability is marginal. Many agencies love to write small business, as the total value of such is often very profitable from a percentage perspective. However, in sheer dollars and in light of increasing competition for accounts, the organization must design and proactively plan to solidify the revenue base associated with the top 20% of accounts. Your top clients are your competitors' top prospects. The agency cannot afford to lose these accounts by taking the relationships for granted. The best performing agencies are using the following tools to measure and increase their retention rates.

◆ *Service Timelines and Stewardship Reporting – In an effort to mitigate the risk of losing larger, more sophisticated accounts, high-performing agencies have implemented value-added service timelines and corresponding stewardship reports. This is important for several reasons as it helps to:*

- *Differentiate the agency and institutionalize the delivery of value-added services*
- *Formalize the agency – insured relationship with tangible services*
- *Provide fee-based services to protect revenue in soft market cycles*

*With the possibility of a hard market on the horizon, this is even more important for brokers to consider and implement. If rates rise, brokers need to be prepared to justify the agency's value. How can your agency communicate price increases effectively without a strong, proven value proposition in place? Systematic execution and communication of a value-added service platform can be a key differentiator for business and also a great customer contact strategy that increases account retention and new business production.*

◆ *Book Segmentation – Segmenting each individual producer's book of business should be conducted in tandem with the installation of service timelines and stewardship reporting. By determining who the best and most profitable clients are, the organization can provide elevated services to them, versus providing deluxe services to all of customers, carte blanche, and rendering some of those accounts unprofitable.*

◆ *Tracking Retention vs. Rate – Some agencies have been very diligent in tracking the market's impact on the producer's book-of-business. For example, a producer with a \$1,000,000 book-of-business may write \$150,000 of new business, but because of the market's impact on their book, they have a net decline versus a producer who does not write any new and receives a 15% increase on their book because of increased rates. Agencies need to continue to focus on producer activity and performance, regardless of market. To truly evaluate producer book performance, book of business growth (or decline) should not be the be all, end all. Consider tracking other key performance indicators such as:*

- *Account size growth*
- *Number of New Accounts*
- *Account Retention*
- *Number of Cross Sold Accounts*
- *New Business Appointments*

Eliminating the market's impact on the book of business allows for the most objective assessment of producer performance.

### **Increase Organic Growth**

Although client retention is critical as a foundation for growth, a focus on retention alone will not ensure agency viability. New business production remains paramount, as the core difference between average and high-growth agencies is not in retention rates (which remain pretty consistent) but in the fact that high-growth agencies write twice as much annual new business compared to average agencies.

High-growth agencies understand that external markets are beyond their direct organizational control and that

the best way to outpace the insurance and economic landscape is to proactively and continually tune the new business production engine. An effective organic growth engine will enable the agency to prosper under any market conditions, and hardening rates will have a multiplier effect as both sales and rate climb in tandem. One of the most effective ways to drive organic growth is to bring sales management discipline to the organization.

It is incumbent upon executives to instill a culture that focuses on new sales. They must give their associates the right organizational policies, practices, rules and tools to promote sales team success. High-growth agencies focus on three key areas that lead to organic growth success: planning, infrastructure and hiring.

### **Planning**

Long-term growth demands short-term monetary investments. Agency principals must reinvest money back into the agency in order to hire new producers, improve technology and streamline processes. These improvements will increase agency stock value over time. Many agencies claim that they do not have any money to invest in a sales culture, but it usually just a matter of agency priorities.

### **Infrastructure**

Agency executives must establish the policies, procedures, expectations and rules of the game under which the entire staff will abide. Clearly defining roles and responsibilities serves as a foundation in building a sales culture. To build or shore up your agency infrastructure, there are several things to consider implementing:

- ◆ *Defining the agency value proposition*

- ◆ *Defining and communicating producer expectations – High-growth agencies have rewritten sales position descriptions to incorporate a mandatory minimum level of annual new business production.*
- ◆ *A pipeline management system*
- ◆ *Ongoing selling skills training*
- ◆ *Measuring and displaying producer results*

### **Hiring**

High-growth agencies recognize the risk associated with an aging production force and reduce this risk by implementing a consistent, systematic producer recruiting, hiring and retention plan. The best organizations are slow to hire and quick to fire. The key is that consistent hiring is seen as a necessary short-term investment to achieve not only organizational revenue growth, but long-term value as well. Creating a sales culture takes time and resources. It all starts with the realization that executives must lead the effort, a commitment to long-term viability, and the acknowledgement that change is good.

### **Conclusion**

Although we don't know for certain if a hard market is imminent, we do know that the best agencies will not rely on external forces to control their destiny. Through diligent planning and execution, the best agencies will minimize their reliance on non-commission income sources, reinvest in the people and systems necessary to promote growth, increase their retention rates and focus on external growth to drive their agency to a future of prosperity.

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