# Signs of the Agency Financial Times

## *7 Key Trends Producers Should Watch to Keep from Being Left Behind*

*By Danny Anderson and Bruce Berthelsen*

In "Left Behind," the first book in an apocalyptic series by Tim LaHaye and Jerry Jenkins, the main characters find themselves scrambling to adjust to the sudden loss of random people around them — thousands just disappear. In the wake of the confusion, people begin to recall that those very missing people told them what would happen. How did they know? Had someone warned them about what was ahead?

While nowhere near as devastating, but serious all the same, changes faced by the property/casualty insurance industry have financial implications that could leave top insurance producers behind wondering how they missed the signs. The industry has always seen fluctuations, but current indicators are harbingers that demand attention. If ignored, they might have unpleasant consequences, particularly for producers.

There has been a barrage of articles covering mergers and acquisitions (M&A) activity and the rise in private equity firm buyers. Most of these articles serve to advise agency owners, but what about producers? Without equity in their book of business or stock ownership, their financial future could be at risk.

The following seven trends should cause producers to reevaluate their current position and how they plan for the future.

**Agencies Remain Attractive Targets for M&A**

With the high valuations, insurance agencies continue to be an attractive purchase when considering a merger or acquisition due to their consistent growth. A recent *Leaders' Edge* executive report stated, "The average insurance firm has sold 12 percent to 14 percent new business as a percentage of their prior year's book of business each year for the past 10 years."

In addition to strong valuations and growth, other reasons for the attraction include certain demand, low risk, high retention rates, and a quick return on investment. As evidenced over the past few years, the industry is resilient even amid a difficult economy.

**New Players in the Game**

While there have been the typical players in the game for years, e.g., public and private brokers and banks, private equity firms have taken the most aggressive growth position in recent years. As recently as 2006, private equity firms made up just 4 percent of buyers, according to a recent Reagan Consulting report. However, private equity firm deals accounted for 54 percent of last year's activity, according to the "2015 Agency/Broker Merger & Acquisition Statistics" report by OPTIS Partners.

Why the aggressive acquisition strategy? One explanation provided in the report is that there is an "abundance of private equity capital and limited options to investors to generate the returns they seek."

**M&A Deal Activity in 2016 Will Remain Strong**

Last year, analysts predicted that 2016 would continue the trend of accelerating M&A growth. While earlier reports this year looked like that would not the be case, it has proven to be true. OPTIS' midyear report stated that insurance agency M&A activity ranked as the second most active six-month period since it began tracking in 2008 — the first half of 2015 ranked highest.

"We anticipate the recent strong industry consolidation trend will continue for the near term as acquisitions are an important growth strategy for many firms, especially those backed by private-equity capital," said Timothy J. Cunningham, managing director of OPTIS.

**Demand for ROI May Mean Lower Commissions**

It's not difficult to imagine that private equity firms, or any buyers for that matter, will want to turn around their investment in a short period of time to get returns quickly out of high-priced deals. For those deals that include an earn-out portion, which is based on future performance and typically a significant part of the sale price, the seller is responsible for not only maintaining the business but growing it as well.

In a warning to buyers, Daniel P. Menzer, CPA, partner with OPTIS, said, "A premium price paid for acquisition can have significant adverse implications on the long-term viability of your agency. If the agency you buy does not perform up to snuff and you do not have the capital base to absorb the shortfalls, you can get in a lot of trouble."

Top producers may be left with increased pressure to perform by bringing in new business, their clients may be moved around, and their commissions may be decreased to meet accelerated goals. With no ownership in the business, they are left with no say in the matter, and their income potential and financial future lie in jeopardy.

**Experienced Producers Leave the Market**

There is an astounding number of experienced pros about to leave the workforce. The average age for U.S. insurance agents is 59, according to McKinsey & Co. As many as 25 percent of the most experienced producers are eligible and expected to retire within the next five years. That leaves the remaining top-performing producers left behind to fill in the gap as the industry struggles to entice millennials and get them up to speed as quickly as possible.

Millennials, while ambitious, likely will not provide the answer in time. It's good news that 69 percent of millennials

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aspire to be leaders in the next five years, according to The Hartford's 2015 Millennial Leadership Survey. In the same study, however, those with an insurance career on their wish list were at only 4 percent, leaving the industry heavily reliant on more experienced employees not only to keep the industry afloat but also to train a reluctant generation.

Additionally, when leadership cashes out upon completion of a deal and leaves an organization after a buyout, they take with them years of experience and leadership and leave added pressure on those producers who remain to perform.

#### Changing Premium Rates

Premium rates are continuing a downward trend in many lines. Business interruption, businessowners policies (BOP), commercial property, professional liability, and workers' compensation were among those lines that saw decreases in the first half of 2016, according to MarketScout.

While commercial insurance rates have been marching downward since September 2015, a soft market and its accompanying rate changes are not always bad news.

"This soft market presents both challenges and opportunities for brokers. Lower rates meant less revenue, but as the economy improved, policyholders were seeking increased limits and additional lines of coverage," said Ken A. Crerar, president and CEO of The Council of Insurance Agents & Brokers (CIAB). "This gave our members a chance to be creative and provide added value to their clients beyond just negotiating lower rates."

#### Decreasing Number of Agencies

While there are conflicting figures on how many insurance agencies there are in the United States – some say as low as 26,000 while others say as high as 40,000 – growth is likely to contract. The most affected segment of the agency population is projected to be agencies under $1.25 million, according to Reagan Consulting, which projects this segment to go from 32,000 to 20,000 by 2024.

"We anticipate the recent strong industry-consolidation trend will continue for the near term, as acquisitions are an important growth strategy for many firms, especially those backed by private-equity capital," Cunningham said. This decrease in the agency population likely will mean less opportunity for producers.

> **'Changes faced by the property/casualty insurance industry have financial implications that, in the end, could leave top insurance producers behind wondering how they missed the signs.'**

Agency owners who did not prepare properly for the velocity of change the industry is experiencing have been caught unaware, and due to that fact, many are highly motivated to sell in the current favorable environment. A recent Agency Revolution survey sheds additional light on this. When asked the question, "Are you worried the world is changing faster than your agency?" an astounding 96 percent of the agent-broker marketplace said, "Yes."

Current agency valuations are high. Baby boomers – who own the lion's share of the primary target agencies – are ready for retirement, and many agency owners are just plain unprepared for the future due to lack of experienced personnel in their pipeline, lagging technology, and a host of other reasons. The bottom line is that the temptation to sell is intense and conditions make selling a no-brainer for some owners because they do not have proper perpetuation plans in place and time has run out.

#### What Does This Mean for Top Producers?

Amid all these trends, top producers have a lot to think about when looking toward the future. They should consider these conditions:

- Agency owners who sell and get out leave top producers with the pressure to perform and less support.
- New buyers, such as private equity firms, will want to get a return on their investments as soon as possible.
- The quality of a producer's client relationships will be in someone else's hands.
- Clients may be moved around to use top producers to accelerate new business growth.
- Commissions may be decreased to speed up return on investment.
- High pressure in a new model after a purchase may mean increased time away from family.
- Tight noncompetes restrict producers from determining their own level of success.
- Without ownership or equity, producers are left with no control over their financial future.

In the past, a producer's goal of achieving double-digit growth each year was reasonably attainable. However, in the projected agency climate, producers may be left with stagnant or greatly diminished growth opportunities. Typical compensation models will be far too binding in the future agency climate, so savvy producers would be wise to research opportunities with agencies where they have the option to own equity in their book of business, own stock, have new and renewal commission levels the same, and have real control over their earning potential.

As Jeff Balcombe said in his recent commentary for the International Risk Management Institute, "Recent Trends in the Valuation of Agents and Brokers," "Companies that truly understand the critical risks and value drivers underlying their business or a potential acquisition target will be able to take advantage of the opportunities to capitalize on the recent industry trends."

It would be wise for insurance producers to do the same. IJ

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