

Increase Your Agency's Value Through Benchmarking, Acquisition & Succession Planning



Introduction

Are you working hard to grow your agency by adding one client at a time? While organic growth is important, equity growth can be accelerated through effective financial management, acquiring other books of business, and proper succession planning.

Many independent agency owners typically start out on the smaller side – depending on their background in the industry. Every business owner knows, the faster you're able to grow, the more successful and profitable your agency becomes. Frequently, owners focus on attracting new clients or expanding into new lines as the primary methods of achieving growth.

While these can be good tactics for organic growth, if you want to supercharge your revenue, secure your retirement and prepare your agency for the unexpected, you also need to pay attention to the financial and business side of growing an agency.

This white paper shares smart financing, acquisition and succession planning strategies that support agency growth and long-term success.

In the following pages, we'll cover:

- 1. How to determine your agency's value
- 2. Key benchmarks to consider
- 3. Growth through acquisition
- 4. The agency acquisition process
- 5. How to plan your exit





Determining Your Agency's Value

Your agency means everything to you, but how much is it worth to others? Knowing your agency's value is essential if you need to sell. It can also be useful in other situations.

Agency finance experts tell us that agency valuations can be used in business planning, shareholder buyouts, M&A transaction support, as well as litigation support, tax compliance, ESOP compliance and even life insurance underwriting. However, most agency owners have never had an agency valuation completed and aren't familiar with the process.

How Is Your Agency's Value Determined?

As an agency owner, you know that there are a lot of factors that go into your agency's worth. Therefore, it shouldn't be surprising that calculating an accurate value for your agency can be complicated.

The *Insurance Journal* says that most agency owners are aware of a "quick and dirty" valuation method that multiplies the earned commission by a certain number, such as 2.0 to 3.0. While this method is easy, it's not necessarily accurate. To illustrate why, the article compares two agencies that both generate \$500,000 in revenue, but one agency is run by a young producer who is actively adding accounts, while the other is run by an agent who's reached retirement age and is steadily losing accounts. Using the quick and dirty method, these two agencies would have the same value, but a potential buyer could see things very differently.

There are valuation methods that take these factors into account. According to the <u>U.S. Chamber of Commerce</u>, there are three basic approaches to business valuations:

- The asset-based approach totals all of your investments in the business.
- The earnings value approach focuses on the company's ability to generate <u>cash flow</u> in the future.
- The market value approach looks at the value of other similar businesses that have sold recently.



Terms to Know

Fair Market Value: The price an asset would sell for on the open market assuming the buyer and seller are knowledgeable about the asset, they are behaving in their own best interests and free of undue pressure, and they have a reasonable time to complete the transaction.

Liquidation Value: The net value of a company's physical assets if it were to go out of business and its assets were sold.

EBITDA: Earnings Before Interest, Taxes, Depreciation and Amortization, commonly used to measure corporate profitability. For privately held businesses, a "pro forma EBITDA" is used that incorporates income and expense adjustments for non-recurring or owner-related items on the P&L.



What You See Depends on Where You Sit



As a seller, Madeleine believes the agency is worth \$6M - equivalent to 3x annual revenue.

Madeleine's agency generates \$2M in revenue each year.

Difference in perceived value: \$2M



As a potential buyer, Mark believes the agency is worth \$4M – equivalent to 2x annual revenue.

Benchmarking for Success

How do you measure success? One way is to focus on your own goals, including both your professional goals and your financial goals. Have you built an agency you're proud of? Are you able to pay your bills and support your family? If so, you've achieved something wonderful.

However, it can also be helpful to look outward. One way to determine whether there's room for improvement is benchmarking, i.e., comparing your own performance to the averages in your industry. Benchmarking can give you an unbiased look into how well you're really performing.

In order to benchmark, you need to know what metrics to use and which agencies to use for comparison purposes.

Every agency has a financial model, even if the owners aren't aware of it. Typically, agencies operate on one of three models:

- 1. A marketing-driven model that generates business through marketing
- 2. A sales force-driven model that uses commission-based producers
- 3. A blended model that combines both.

The model below illustrates the expense benchmarks that lead to solid net profitability. For example, if you're using a marketing-driven model, your total expenses should account for about 48% to 66% of your revenue, and your net profitability should be 35% to 53%.

	Marketing Driven	Sales Driven	Blended
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SALES EXPENSES			
Commissions	0%	25-30%	10-15%
Meals, travel and entertainment	0%	1-2%	1%
Marketing, advertising, and promotion	3-6%	1-2%	2-3%
OPERATING EXPENSES			
Salaries & wages	25-30%	20-25%	25%
Benefits (PR taxes, insurance, 401K)	6-8%	5-7%	5-8%
Occupancy (rent, utilities, R&M)	5-8%	5-8%	5-8%
Phones & technology	2-3%	2-3%	2-3%
Printing, postage & supplies	2-3%	1-2%	2%
Business Insurance	1.0-2.5%	1.0-2.5%	1.0-2.5%
Other	3-5%	3-5%	3-5%
TOTAL EXPENSES (full range)	48-66%	64-86%	56-73%
NET PROFITABILITY (full range)	35-53%	14-36%	28-44%
TOTAL EXPENSES (full range)	40-50%	25-35%	30-40%

*Exclusive of owner's salary and benefit, depreciation/amortization and interest on debt.

Most applicable for agencies with revenues > \$300k

Source: AgencyBrokerage.com

Another good resource is the <u>Best Practices Study</u> from the Independent Insurance Agents & Brokers of America. Each year, this study covers the leading agencies and brokers in the country to provide performance benchmarks and help agency owners develop successful business strategies to improve.

Growth Through Acquisition

When you attract one new client, you secure one policy – or maybe a few policies if the client has multiple insurance needs. When you acquire another agency, you secure hundreds or even thousands of new policies all at once.

You can build your agency one client at a time, but an acquisition can be a much faster way to achieve growth. Acquisitions can also be a fantastic way to expand into new territories, niches or lines.

Mike Strakhov, the Senior Vice President Agency Banking Market Leader at Westfield Bank explains:



Mike Strakhov

If you started with an agency with \$1 million in revenue, you would need to achieve a compounded annual growth rate of 5% with a 90% retention for about eight to nine years to grow that revenue to \$1.5 million.

However, if you leverage acquisition, you can achieve much greater growth in a much shorter timeframe. "It could be a four-to-six-month investment, one transaction," Strakhov says.

Building a successful agency is hard work, but you don't have to make it harder than it needs to be. Every agency owner should consider the potential of growing through acquisition.



Case in Point

Lee Ann Pridgeon, owner of AllCare Insurance Service, is a shining example of how agency acquisition can drive growth.

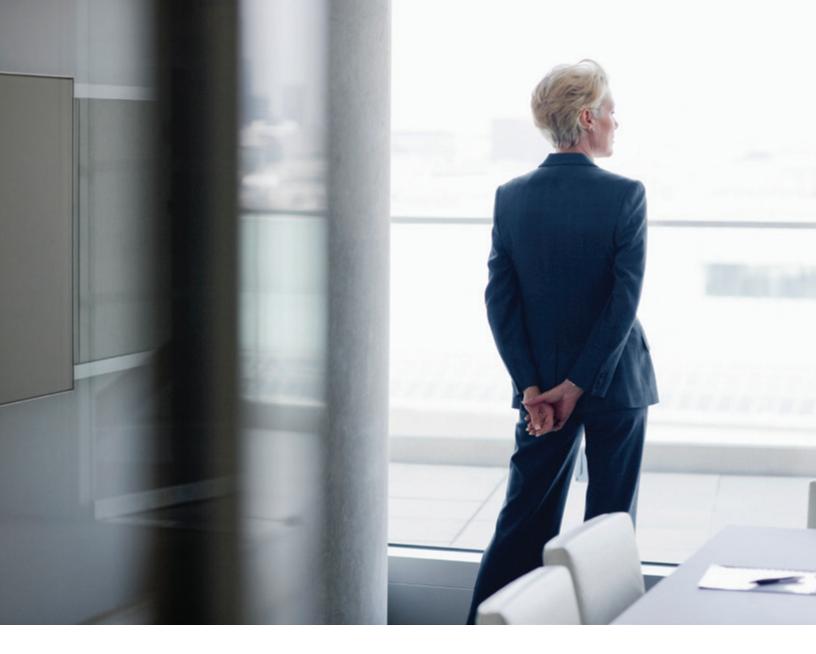
She purchased her first agency in 2008 after working at the same agency for 15 years.

Then, between 2015 and 2020, she acquired seven additional agencies. The acquisitions helped her grow faster than she could have organically, and through acquisition, she also accelerated her expansion into commercial lines.

When Should You Acquire?

Everyone's circumstances are different, and you must make decisions that make sense for you. However, there are some situations when it makes sense to acquire.

- You want to become an agency owner. Many insurance professionals build their first independent agency from the ground up, often after gaining experience as an agent. However, acquisition is another way to get started as a business owner. For example, if the owner of the agency where you work is planning to retire, you may want to purchase the agency.
- You want to fast-track growth. Finding new clients can be difficult, especially when competition is fierce and most of the potential customers in your area already have strong insurance relationships. If you want to achieve growth fast, acquisition may be the best way to achieve your goal.
- You want to expand into a new region. Maybe you're in Denver, Colorado, and you want to expand into Boulder, or maybe you want to move into another state. Expanding into new geographic areas can be an effective way to grow your business. Compared to the work involved in finding new customers, meeting the state licensing requirements may be the easy part, so an acquisition may be your best bet.
- You want to expand into a new line. Let's say you specialize in personal lines, but you want to add commercial lines, or maybe you only sell P&C insurance, and you want to add life and health. Offering more products is a great way to increase your sales because it means you can sell multiple policies to a single client. It can also boost retention since customers may be less inclined to leave if they have multiple policies with you. Acquiring an agency can be the fastest way to take on new lines.
- You want to add a niche. Perhaps there are a lot of construction businesses in your area. You'd like to break into the contractor niche, but you're having a tough time gaining a foothold. Buying an agency that's already established in this niche could be the solution.
- An opportunity falls into your lap. Sometimes buyers seek out targets to acquire. Other times, sellers seek out buyers. If someone offers you the chance to buy an agency, you have to decide whether it's a good move for you. Even if you weren't planning to buy an agency right then, you might realize that the opportunity is simply too good to pass up.



What If You Don't Have the Cash?

Many successful owners built their first agency on a shoestring budget. If that's what you did, and even if you're successful now, you might think you simply don't have the cash needed to acquire a second agency – much less a third or fourth.

Don't be so sure.

You may be able to secure a loan to cover the cost of acquisition. There are several financing options available, including Small Business Administration (SBA) loans, bank loans and mezzanine capital. Additionally, the seller may secure financing for part of the transaction in order to close the sale.

The bottom line: Don't assume that an acquisition isn't possible just because you don't have a hefty sum sitting in your savings account.

If the agency you want to purchase is profitable, it could mostly pay for itself, just as buying a rental property can pay for itself. It's worth your time to speak with some experts before ruling any options out.

The Agency Acquisition Process

Step 1: Outline your strategy

Step 2: Set your target

search criteria

Step 3: Identify potential targets For example, if your goal is to expand into a new market, you'll want to focus on targets that are established in that market. When you have a list of your target search criteria, you can start looking for agencies that match and reach out to them. Some agency owners may not be interested, and that's fine – their interest level will help you quickly narrow your scope. You can move forward with the valuation process for those who are interested.

If you haven't done so already, this is also a good time to explore your funding options. Most buyers don't have the cash to fund a deal, so they need to secure financing. Your acquisition hinges on financing, so Strakhov says you may want to start looking at your financing options earlier in the process – don't wait until you need to finalize financing. "It's never too early to start thinking about finances," he says.

Step 4: Contact potential targets

Step 5: Perform initial valuations for interested agencies Once you have identified a potential target, you need to determine whether you want to move forward. This requires more information. At this point, you won't be able to take a deep dive into the agency's details – that comes during the due diligence phase – but you can request enough information to give you a fairly good idea of what the agency is worth.

Strakhov recommends asking for three years of financial history, three years of commission and contingent income by carrier, a summary of the active book of business, loss reports for top carriers, and an employee roster that includes salaries and job descriptions. If an agency valuation is available, you should ask for that, too.

Step 6: Secure financing

Step 7: Execute letter of intent (LOI)

Step 8: Perform due diligence Once you're serious about buying a target agency, you move forward with a letter of intent.

Investopedia says a letter of intent is a document declaring a preliminary commitment of one party to do business with another. In terms of agency acquisitions, Strakhov describes the letter of intent as a short, non-binding offer that outlines the deal terms, the expected timeline and the requirements for the deal. It also often includes an exclusivity period of 90 to 120 days. This pulls the agency off the market temporarily, so the seller won't continue to accept bids while you're trying to finalize the deal.

<u>Divestopedia</u> says the letter of intent is a big step that you shouldn't take lightly. Although you can back out of the deal, if you do so without good reason, it can give others the impression that you're not really serious. This could potentially hurt your chances of finding another agency owner who's willing to negotiate with you.

That being said, you CAN and SHOULD back out or insist on re-negotiations if you have good reason to do so. After you execute the letter of intent, you need to perform due diligence, and this is the step that can make or break the deal.

According to <u>The Balance</u>, in business, due diligence refers to a specific process that you go through to examine a business transaction before closing the deal. Although you may already know a little about the agency based on your preliminary research, the goal now is to verify the numbers and understand what they mean for the deal. Experts warn that this stage can be overwhelming. There's a lot that you need to review, but the information can be broken down into three categories:

• Financial – You need to dig into the numbers related to revenue and expenses. To verify the information, you'll need to look at tax returns and P&Ls, bank statements and reconciliations, carrier statements and management system reports. You'll also need to assess trends and make projections; Mike Mensch with Agency Brokerage says to be conservative when doing so, and to watch out for inaccurate data, non-recurring income and client and producer concentration that drives revenue.



Mike Mensch

- Operational You need to understand the agency operations, including relationships with carriers, the organizational structure and employment-related policies and IT systems and workflows.
- **Legal** You need to review legal documents, such as network contracts, employee agreements, licenses and insurance policies.

Before you get scared away from the idea of acquiring an agency – you can hire a due diligence company to perform this important process for you. The average agency owner doesn't necessarily have the expertise needed to conduct a thorough due diligence process, and because the stakes are so high, hiring a specialist makes sense. Having a third-party handle due diligence can also help you maintain a pleasant relationship with the seller even if the process gets tense.

A meticulous due diligence process reduces the risk of unpleasant surprises down the road, but there's always a chance that something will be overlooked. For example, there might be an issue that doesn't come up because no one is even aware of it yet. That's why you might want to consider representations and warranties insurance. According to *Insurance Business*, representations and warranties insurance, sometimes called warranty and indemnity insurance, provides coverage for unknown and unintended breaches of representations and warranties made in business merger and acquisition agreements.

Step 9: Negotiate the purchase agreement and close the deal If due diligence checks out and everything is as you expected, you can move forward with the purchase agreement.

This may take a while. According to <u>Investopedia</u>, timelines vary considerably, but a merger or acquisition can take anywhere from six months to several years. Large corporations – think Fortune 500 companies – probably drive the longer end of the spectrum, but even for smaller companies, this isn't a process you want to rush.

Once you've finally closed the deal, you can take a moment to celebrate, but your work isn't done yet. Now you need to integrate the agency and its team into your operation.

Step 10: Integrate the agency

The importance of new agency integration can't be overstated. To see why, just consider the transaction from the point of view of the employees. If the agency you worked for sold to new ownership, you might be worried about your continued place in the company. If you didn't like the way the deal was managed or the changes that followed, there's a good chance you'd decide to leave.

According to MIT Sloan School of Management, 33% of acquired workers quit in the first 12 months, compared to 12% of regular hires.

Now consider what happens to the agency's revenue if your top producer – or even worse, your top two or three producers – suddenly quit because they're unhappy with the sale. All the revenue projections you performed during due diligence were based on those producers continuing at the agency. Now that they're gone, revenue may drop, and you won't have what you paid for.

You can avoid this scenario with a well-planned integration. The existing owner plays an integral role in ensuring a smooth transition, and you need to have agreement on the company culture, the name and the policies before you move forward, and there should be transparent communication whenever possible so there are no surprises after the fact.

The Importance of Planning Your Exit

At some point in your career, you will need to plan your exit. Sometimes agency owners plan their exit years in advance. Other times, they have to sell their agency fast due to unexpected circumstances. Agency owners sell for four common reasons:

- 48% sell because they are retiring.
- 21% sell because of market conditions.
- 23% sell because they want a change.
- 8% sell because of health issues.

When you sell your agency, you want to make sure you get a good deal. If the sale is funding your retirement, this is critical. You may also have other strong opinions about the fate of the agency you worked so hard to build, like what will happen to your name, your staff and your clients. Having a plan in place can help you maintain control of the sale.



Angela Adams

"Why should you plan your exit?" Angela Adams with Angela Adams Consulting asks. "The biggest reason is because it's going to improve the value of your agency."

Adams explains that having an exit plan can help you improve the value of your agency, set the price and terms, minimize your tax liability, avoid a distressed sale, ensure a smoother transition process and protect your family, customers and employees. If you don't plan your exit, you can be forced into a distressed sale, and that's never to your advantage.

You Need a Partner

Financing, acquisition and succession planning are part of a smart agency growth strategy, but many agency owners find that they need support.

- As an interested buyer, you need to find agency owners who want to sell.
- As an interested seller, you need to find potential buyers.
- You may also need support managing the business details and securing financing.

Want to learn more, watch these webinars:

Valuation and Benchmarking

Perpetuation Planning

Acquisition Strategy



RESOURCES

WESTFIELD BANK

At Westfield Bank, we understand the unique needs of your insurance agency and our experienced team of bankers partners with you to personalize financial solutions that empower your agency every step of the way. We offer Agency lending to grow your firm through mergers, acquisitions, and perpetuation, plus working capital lines of credit, producer loans, and real estate.

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