"A Modified Stationary Panic"

By
Dan Romain

Hello America!

Welcome to the Broker's Path newsletter!

If you missed my articles in *The Hales Report,* allow me a brief introduction. For nearly two decades, I was an average Producer (Google: "Urban Legends"). Eventually, I found myself as the President of a $7-million dollar *Assurex* Agency. In the seven years that followed, my partners and I grew the place to a run-rate of $20-million. Bobby Reagan's *Best Practices Survey* (I'm a fan of Bobby and that report) ranked us at the tippy-top in all categories. Later, we monetized our equity (weasel words for: "we sold") when silly money roamed the land. After a few months of "retirement", the gold-standard firm we chose to handle our negotiations; Hales & Company, asked me to spearhead their consultancy practice. Last year, at age 53, I founded Broker's Path, an operational consulting firm comprised of folks who fought in the trenches, just like you.

Now, on to business…

"Lot's Wife"

This newsletter is a bit unusual, even for me. That's because an 800-pound gorilla has been going do-do in Agency board rooms for the past two years and not one credible "industry resource" will offer you any advice on how to deal with the mess. It's up to you to figure out when this economic dumpster fire will burn itself out and what you should do in the meantime.

I suppose tackling this all consuming issue in my inaugural newsletter runs the risk of being industrial strength stupid. It may seem a little presumptuous as well, but I don't care. Everywhere I go Agency Presidents are imitating Lot's wife, frozen stiff with indecision, stuck in a modified stationary panic while Congress rolls more legislative boulders down Capitol Hill.

Well, my dear friends, "*steady as she goes*" is the last thing Edward Jones said to the helmsman before he left the bridge of the Titanic. Things got a little bumpy after that. The point is that we need to talk about bridging the gap between now and that down-the-road day when the economy is on even keel again.

For the record, thirty some years ago the President of the Alpha Chapter of Washington State inducted me into a nerdy economics honors consortium called *Omicron Delta Epsilon-The International Honor Society in Economics*. Since then, I've come to realize that most economists know less than my Labrador about real world economics. For many of them, the big decision was "weatherman" or "economist"? (The skill set is the same.) Both tell you what the conditions are right now. That's where my thirty years of doing what you do comes in. That, and listening to a suburban load of my hunting buddies, who just happen to run multi-billion dollar hedge funds, gives me something I like to call "perspective".

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- ✓ ***"I keep hearing that the recession is easing. Consumer confidence is up. Retail sales are promising. The market is hovering around 11,000. Unemployment numbers have moved from 'sucks' to 'sucks less'. The problem is that my customers are all hurting! Exposures are down. The market is hideously soft. I don't see things getting better anytime soon."***

(Paraphrasing just about every agency I meet.)

<u>Short Answer:</u>

There's no such thing as a "jobless recovery". What you have now is what you'll get more of over the next two years. Hiring will pick up in 2011… sort'a.

The funny thing is that *YOU ALREADY KNOW!*

Collectively you (all) insure America's predominant employers: small businesses from A-to-Z. You talk to owners every day. If you don't know what's really going on economically in your area, no one does. Your livelihood requires an in depth business operations poll of sorts with every client you have (A.K.A. *Renewal Review*). You are more dialed-in to what's going on than any other group in America. The problem is, that because you've weathered things comparatively well, thus far, the answer you have (things suck) is not the answer you seek (things are better now).

Things will suck on Main Street for at least for two more renewals and you know it. Your cash-flow will get tighter. Your contingency checks will shrink even more due to recession loss ratios and little growth. Admitted carriers acting like cash-flow Bermuda captives aren't helping much either. The expense reductions you've taken thus far aren't enough to cushion you if something unexpected occurs. You can cut more, but the real solution is to juice the top line and you know it. You've struggled with that like everyone else so, in turn, you sideline a few low level employees and spread around the work. There's a better way, and we can help.

<u>Long Answer:</u>

"*The unemployment rate is holding steady."* (No, but go ahead and think that if you want.) *"Sub Prime foreclosures are trending down.*" (Banks have suspended foreclosures so that they don't have to face the music.) *"Public Works contractors are feeling the Stimulus money."* (And then they won't.) "Wall *Street is up 70% since the low and still on a bull rally."* (Yep! 12,200 by the end of the year is my bet. Food Stamp recipients are up 70% too. But, in fairness, two quarters of positive GDP growth, soon to be announced, means we are in a recovery. Economists will declare that in about four months, retrospectively of course.)

Let me explain the stock market in the past twelve months, compliments of my friends who trade billions each quarter.

The Fed & Treasury are funding <u>the stock market rally</u> via the arbitrage on investor's near zero cost of funds that were initially deployed on T-Bills and are now in Asia (excluding Japan), Brazil, India, and more recently Canada, now that the loonie is on par with the dollar. This will last right up until the day that the Federal Reserve is forced to nudge interest rates higher. The Fed told investors "free money for an extended period of time". That's all Wall Street needed to hear. Which begs the question; why hasn't Wall Street spurred job growth?

The answer is: that it has. The problem is that most new hired workers speak Mandarin or the Queen's English in India. Yes, Caterpillar, Apple and GM have revved up some shifts. That's because their Asian facilities are running at full capacity. India and China are now domestically consuming a lot more of their own cheap goods. Proof: China posted its first *trade deficit* in years!

TARP, STIMULUS, and an 11,000 DOW haven't eased the credit crunch. No credit, means no Main Street and more home foreclosures. Financial institutions which got free money from the Fed gave it to Turbo Tax Tim's Treasury and booked 3% on T-Bills at zero risk. The stock market, Junk and Corporate Bonds are competing against T-Bills right now. That's driven the market up. Capital is moving towards equities (stocks) with greater velocity because of things occurring elsewhere. Those stubborn enough to short the market have taken it in the shorts.

Meanwhile, the Fed bought underwater bank mortgages through Fannie and Freddie at 2007 home values. Contrary to popular opinion, Fannie and Freddie's ability to sell mortgage backed securities drives interest rates and the Fed stopped buying that stuff on April Fool's Day.

The same goes for the dollar. Contrary to what you might hear, the dollar is not stronger recently. Its purchasing power is 28% less than it was eight years ago. Could we have any more gold commercials? All currencies have fallen. (Yes, even China's Yuan was maneuvered downward 9%). It's just that the dollar sucks less than the Sterling, so the dollar is "up" relative to the sinking Euro, for example. (Currency trades require one currency to be sold simultaneously for each purchased. Thus, currencies display *relative* strength and weaknesses.)

The old adage is; commodities lead stocks to recovery. It's old, because it has worked that way for a very long time. This is what we are seeing now in the market. All commodities have been on a roll. Silver has almost doubled in two years. While that sounds like a good thing, just remember oil and food are commodities which, again, stirs inflation.

(Real life example: Gasoline was 25 cents a gallon when JFK was in office. Two silver quarters bought two liquid gallons. Silver is now $18-something an ounce. Two silver quarters are worth roughly eight dollars today in melt value. Subtract the coin premium and you get roughly $3.25 a quarter ounce of silver (a 1963 pure silver quarter) or roughly two gallons of gas! Two silver quarters buys two gallons of gas today, as it did 46 years ago.)

Inflation (CPI) is currently 1.08%. That index includes very large items such as cars, computers, flat screens, bulldozers, complex electronics, etc; all of which are cheaper today than they were in the past. The CPI-*adjusted* figure measures; food, utility bills, insurance, tuition, gasoline, cable, etc; basically the stuff you buy every day. That "inflation" figure was 4.2% when Light Texas Sweet (oil) was trading at 68-bucks. Oil is $80 a barrel as I type. Gasoline will be $3.50 a gallon by July. China's increased oil consumption almost makes up for US reductions. Now that OPEC nations use 30% more of their own oil then they did just five years ago (at a cost to them of $7.00 a barrel), oil demand is still quite strong even though it's weak in the US. Unfortunately, off shore oil wells drain twice as fast as land based wells and 97% of all new oil reserves are "underwater" so to speak. China's cheap export model will get equally hammered as bunker oil (ship fuel) prices continue to surge and oil prices rise. Eighty percent of all Chinese buildings have *zero insulation!* Insanely cheap goods are not sustainable without cheap oil.

Unemployment came down to 9.7% because 2008 jobless workers fell off the 99-week subsidy ranks so they weren't counted anymore. New college graduate unemployment is officially at 19%. The U-6 measurement of un/under-employed (old school) is almost 20%!

That number continues to climb in spite of Census Worker employment and Federal hiring. The incentive for Wall Street companies to refrain from hiring in spite of record profits will persist because productivity indexes per worker are soaring, which one would expect. (Exceptions like Home Depot increasing hiring notwithstanding.) Rising productivity per worker means higher profits period! Public corporations are swimming in cash and the stock price for those companies reflects their current profitability. Hiring is a negative stock influence, so it's not going to occur until the market share erodes and that's highly unlikely in a low consumer driven model. Baby boomer consumption peaked *before* the recession and consumers are de-leveraging, saving, and buying "living goods" rather than *standard of living* goods. Translation: Wall Street isn't motivated to hire in mass anytime soon. Mergers will be the next wave. Then, and only then, will hiring begin to resume, provided something unexpected doesn't occur.

Even China has Wall Street nervous that they are in a capital bubble right now. Chinese real estate prices soared 61% last year in many provinces. As a result, Wall Street is focusing on India, led by the most conservative central bank in the world! (India refused to recognize credit default swaps, for example.) Resource rich Brazil is booming. In short, Europe (sans Germany) and America are experiencing a time honored insurance malady called "adverse selection". This is the "new normal". I'd like to say "get used to it," but that's the problem! Everyone seems to be settling into this new condition. That's not a good strategy, for you, going forward!

Post Script

The point is, that there are very good reasons why Wall Street is thriving and why Main Street isn't. Prime mortgage foreclosures are up 25% from last year, 39-million Americans are on the breadline (A.K.A. Food Stamps), home values are declining, rumblings of trade restrictions with China are increasing, public pensions are driving cities and municipalities towards bankruptcy (states can't seek bankruptcy protection or they would), vacancies throughout commercial real estate are causing regional banks to basically lock-down, and all of those everyday items we are buying keep inflating in price. We don't need to address; healthcare legislation, the Bush tax cuts ending, marginal income tax increases, payroll tax increases, the soon-to-be-debated Value Added tax (VAT), the 10-year T-Bill rate rising (thus costing us much more to borrow), or a billion dollars a day (and growing) interest we pay on the debt… to understand why your best contractor can't get surety backing without selling his belly-dumps, just to bid a low-end job for the county at zero profit, so that his best crew gets a paycheck rather than staying at home watching cable news which keeps saying how great Wall Street is doing.

But, like I said, you already know this.

What Agencies Should Do Pronto!

All Agencies:

✓ <u>Don't even think about selling externally</u> unless you're spending quality time with your Oncologist. Public Brokers are trading around 8-times EBITDA, which means you're looking at 5.75-times or roughly 1½ times revenue. That's a little understated, but I'm more right than wrong. Selling internally is your best option, if you're inclined to do something in the next three years. You'll command a better price and in a couple of years, seller paper might bring you an additional 10% in interest on the debt service when you retire. Unfortunately, only the larger platform firms have cultures designed to pull that off. You can too, but you'll need some help.

- ✓ Take-on underperformers. That goes double for "your team" if you maintain a book and run the place. Chances are you have blinders on and/or your team feels untouchable because they work for Mr. Big (you). The rest of the agency knows that by the way. If that's you, it's your *Numero Uno* problem. This is why I founded Broker's Path, to help you with these types of dilemmas.
- ✓ Buy smaller shops on renewal like we did in the 70's and 80's. The smaller the better because contingencies will become hypersensitive to personal lines and small commercial growth. This is my favorite initiative right now because you're buying revenue with the other guy's money. It's cash-flow positive, immediately, and there are scads of these types of agencies in your locale. Take a marketing Rep to lunch and start asking questions…
- ✓ Like you, I have no idea if "repeal," "defunding," "state's rights," or constitutional challenges will unwind Healthcare legislation. What I do know for certain is that providers will seriously raise rates in order to build surplus before they are held to an eighty percent claims payout and forced to accept pre-existing conditions on an individual basis. That will elevate the debate, not minimize it. Regardless, you should:
  - Temporarily discontinue new business incentives on Benefits and convert all compensation to net book growth. You should be at that point anyway.
  - Fee your Benefits accounts as much as you can. If you can; offer actuarial services, wellness, and HR consulting. Then focus new production efforts to the 100-plus groups where self insurance with a stop loss protects the employer on the down side. These plans will be the last to cave-in because they will realize savings, especially in year one since twelve months of premiums will cover 10 ½ months of claims as you run-off claims from the old polices. Your new clients will be even happier as standard plans rates rise.
  - You must convert non-Benefits Producers, who cross-sell Benefits through their partners, to a two year referral compensation model. Tell them you'll return to the old standard once things become clearer. This one is tricky, so call us first! Calling last year would have been even better. Calling a year from now will result in copious sighs.
  - Get out of individual Benefit plans, yesterday! There's some nut down the street who will be willing to pay you on a renewal basis, so unload that stuff on Mr. Delusional. Then consolidate your support payroll.
  - One thing is certain, if you're not large group oriented right now, your Benefits revenue is a wasting asset. Benefits Producers struggle to cross sell the P&C because their client (buyer) is the CFO, HR, or someone who reports to the guy who buys the P&C coverage (owner, CEO, Prez, etc). So, converting a Benefits producer to P&C has always been tough, though it can happen. For now, do the above and just hang tight for a year.
- ✓ Personal lines revenues will continue to erode as home values drop, empty nesters reset their lifestyles, and 150,000 miles on a car becomes more common. Get everything in service centers immediately! Then bolt-on smaller agencies which are insanely profitable. It will drive your contingency checks. "On renewal" or "right of first refusal" terms are all around you. Start looking around for those opportunities. That agency (those guys) are small, typically older, and are about to get squeezed. Pay them 40% on all their revenue for the next few years and 1½ times at 30% a year for four years once they retire. You'll smoke growth and profitability

triggers in your profit-sharing formulas. Trust me. This will be a home run! And, your stock evaluator will count this as growth! DO IT!

✓ Workers Compensation in Canada collapsed a few years after they passed Healthcare. Every injury suddenly became work related and providers (Docs) knew the Comp Carrier would pay prescribed (better) rates and patients would receive priority services. Workers Compensation is a really big question mark going forward if things stay as they are now. Comp drives new business, brings value added services to the prospect/client, justifies fees, and is integral to growth and retention. But, I've talked with Comp Insurers. Four of them sent a letter to Congress warning Workers Compensation would take the gas-pipe. Don't react just yet. Wait for awhile. In the meantime, elevate this issue to your crew.

Large Internally Perpetuating Firms:

Shall continue to inherit the earth.

I guess there are two issues that seem prescient for you.

1. Rededicate yourself to backroom service models for your branches. That, by definition, will lead you to some Producer book consolidations that your branch manager has resisted in the past. Press the issue(s).
2. Because comparative values have fallen, your stock value will lag, perhaps dip, even if you grew last year. Two things will occur. First, near-retirement stockholders may get the itch to tender their buy/sell options now that the three year average effect on the stock will put downward pressure on their retirements. That's fine, but not if two or more leave simultaneously. Pass a board amendment that states no more than 30% of the stock can be redeemed in any two year period at the contractual terms. Beyond that, the buy/sell extends the repayment to ten, fifteen, or twenty years to ease the cash-flow crunch.

   Conversely, senior stockholders may postpone their exit given current trends. They own their stock and take home the distributions each year, unlike the youth who stroke checks back to the agency paying for stock. We faced this issue in the past and have found some clever (and fair) ways to make this work out. Call us.

   Secondarily, young stock buyers will hesitate to purchase a declining stock; opting, instead, to pay off current obligations as the value drops. When combined with the forces outlined above, ownership will begin to weight more heavily towards the older owners and therein lays the trap. We know exactly how to deal with this and it involves very smart CPA maneuvers and financing methods. Call us.

General Stuff

Insurance company balance sheets are on the mend due to the stock market. The already soft insurance market will grow much softer as cash-flow underwriting continues. By mid 2011, interest rates will rise on the heels of oil costs (denominated in dollars) and all the Yuk (above). That's when a 1970's recession will revisit us. Lessons learned from those earlier days include:

- ✓ Negotiate volume rather than loss ratio contingencies if you're losses are bad.
- ✓ Cut-back on "draws" to 80% of projected income and true-up each six months.
- ✓ Deal with bad debt, late pays and all things Accounts Receivable now!
- ✓ Declare dividends at yearend rather than simply ordinary compensation bonuses.

- ✓ One-time debt stockholder, debt forgiveness is extremely tricky, but legal if done right and can save you a pile of cash, some of which you'll need to help cover the imputed tax obligations. Call us.
- ✓ Take seriously the Wells Fargo advantage for clients in need of working lines of credit. Network with regional banks that are still open to new customers and help facilitate that paring with clients.
- ✓ Remember "clusters"? Joining one, if you're small, or forming one, if you're large, for the purposes of cobbling together revenues for contingencies and operating margins will come back into vogue in 2011. There's your head start. Do it!
- ✓ Insist, beg, and bribe senior Producers to accept a one-on-one mentoring of a newbie Producer. There are very good ways to incentivize this. Call us.
- ✓ Staff telecommuting works and cuts operational expense significantly. Call us.
- ✓ Communicate results each month. Don't just send an email. Your employees are scared of the unknown, so make things known. Don't sugar coat or embellish. That never works.
- ✓ Build wide support with youthful Producers. You'll need their support as things get a little dicey with Mr. Big-time Producer whom you've had to try to "manage" because he thinks he's immune from all "the noise". (Maybe he is, by the way, which means we have our work to do!)

Take our call when we reach out. We only do a few engagements a year, (deep dives) so most of the time the advice we provide is on our nickel. We're fine with that.

Regards,

Dan Romain
President

BROKER'S PATH

Direct **503.577.3866**
Fax via email
dan.romain@brokerspath.com
www.brokerspath.com

P.O. Box 91629 * Portland, Oregon 97291