Pathways Report

"Personal" Preference

By
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Great to be with you again!

Yes, we've been away for a few weeks. The yearend mad dash to avoid higher taxes (that never came) resulted in a pile of operational activity for us. And, we weren't alone. From what we hear, our M&A friends at Hales were swept away in a flash flood of "time to buy/sell" engagements, as well. If you want to talk *inside baseball* about all of that, give us a call. We're Switzerland. We don't do M&A, per se.

Anyway, this month's **Pathway's Report** may surprise you. That's because it surprised me, too. I thought: *"Cripe! Really? They* (you) *don't want to hear this."* But, here's the thing. This "thing" needs some air-time. Unfortunately, most Agency Presidents (with the possible exception of the really smart ones) squirm when the subject comes up. I wouldn't even bring it up but for the fact that I'm thinking about declaring this "thing" the Numero Uno "thing" you can do this year to juice pre-tax; grow agency value and spin-off cash for perpetuation, if you're so inclined. Look, it's been thirty years since you sat still for this discussion so just sit back, pour yourself an adult beverage and let's talk *Personal Lines!*

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HEY! I SAID "SIT BACK!" WHERE DO YOU THINK YOU'RE GOING?!

Yes, I said "*Personal Lines".* And, yes, I am still taking my meds. Thanks for asking. Just hear me out. I realize that you gave the Personal Lines Department an obligatory *Waa' Who!* shout-out at the Christmas party. And, I know that you will spring for lunch when Safeco delivers your profit-sharing check next month. But, I'm supposed to be your cash-flow "id" and I have something to say to your large account super ego!

"THINGS NOT ON THE PROFIT-SHARING LUNCH MENU"

- Privately, Personal Lines makes your head hurt. You never quite understood how those wonderful ladies (typically) manage to do whatever it is they do all day long... day after day. It's the damndest thing for which you are very grateful.

- You've delegated (then ignored) Personal Lines operations to someone who runs it with an iron fist. She (typically) got the job by being extremely competent. So much, so those who work under her don't just feel inferior. They *know* they're inferior! That makes up for the fact that your supervisor has all the sales aptitude of Godzilla visiting Tokyo. But, who cares? The last time you put one of your partners in charge the whole unit almost quit! That and you haven't had a complaint from a client (or Producer) about Personal Lines in a very long time. *Perfect*!

- You freely admit that have no idea how to grow personal lines in any meaningful way which puts you ahead of your competitor, who has never even given the notion a second thought. You tried in the past and, thankfully, it was so long ago that you've forgotten what you actually tried. You vaguely recall that it fizzled-out and that there was a carrier involved. Still, you're not comfortable taking it off your "to-do" list because there must be something there.

- *After* you pay the CSU handling charge, at least forty percent of your Personal Lines revenue hits the bottom line. Baring an Uninsured Motorist T-boning your loss ratio, you can deposit another four percent (+/-) after your profit-sharing lunch.

- Ironically, forty percent of your Personal Lines revenue will hit the bottom line next year if you stop reading this ***Report*** and do absolutely nothing. It'll just be forty percent of a smaller revenue number like last year.

- Like all those who've gone before, you have no earthly idea how to juice Personal Lines. If you did, you'd do it a heartbeat. It prints money. After you book it and put it to bed, someone else services it. There's virtually no E&O: no "entertainment" expense, no room full of accountants pouring over statements, no bombastic Producers... just steady, profitable, wonderfully boring, "I'll be in Hawaii for the next five weeks," kind'a biz you wish you had more of. Thankfully, you have never been asked: "Why can't we do more with Personal Lines?" by any of your partners and you never will unless one of their clients has a beef.

- There's a four million dollar shop in town that is 80% personal lines. It's been family owned for fifty years. They are at peace with the world and everyone, and I mean every last person, processing oxygen on planet earth, loves them including the two large commercial accounts they write, accounts you stopped calling years ago.

- In contrast, there's another shop across town: Goliath General. It's the largest in three states, or so they say. It too, is internally perpetuating, only "produce or perish" isn't a threat. It's a promise, one they seem to take great pleasure in fulfilling. A million dollar Producer at Goliath gets to park anywhere he/she likes across the street in the gravel lot... a place their *real* Producers used to park. Recently, Goliath's CFO noticed that the Personal Lines revenue in Branch #6 has gone down fifty percent over the past few years. When things were rolling, he hadn't noticed; now he has. As a result, Goliath's CEO added the topic to the Board agenda under the heading: "Is it time to sell our Personal Lines Book?" The last time this came up, it was a pretty close vote.

- There have always been a few Credit Union Insurance Agencies in town, but one in particular, sort of snuck up on you. Your Market Rep (their Rep too) claims that they are up to fifty employees and their branch near Goliath's Branch #6 is expanding. That is so weird because the one and only time you tried to partner-up with a Credit Union it folded like a cheap Gypsy tent after your "shared employee" quit.

And so it is with Independent Agent's most profitable product line. Collectively, you now write a fractional percentage of it across these fruited plains, conceding defeat to animated lizard commercials and bloodless online "Progressive" systems, devoid of human interaction on a magnitude that would make the IRS jealous.

A CASE TO BE MADE: PERSONAL LINES

According to the good folks at Reagan (Hat tip: *Best Practices Report*) Personal Lines is no less than 14% for most of you and considerably more for many of you. Start-ups do roughly 30%, but even $10,000,000 outfits do a lot (17% blended average). It's at least 25% of the revenue you bought when you folded-in a smaller agency. It's also highly valued in agency enterprise calculations. Moreover, it's pretty stubborn revenue. It leaks out the back door, but it's never a dam breaking like Commercial Construction, for example. In fact, it's actually damned hard to run it off. I mean... just think of some of the bonehead things you've let someone talk you into doing!

It's written somewhere that you can't say "Personal Lines" without saying *"...and Small Commercial,"* because they're kind'a related in a stretched comparison sort of way. But, in the past few years, Small Commercial (Select) has gotten more expensive to hang onto. Everything gets shopped nowadays because small business *is the big deal* in America. Exposures are down and losses are up. Many have closed their doors. In spite of all that, Select business still makes good money, just not like before and, if you looked under the hood, I'll bet "earned" is outpacing "written" for many of you. That lack of growth puts a hex on your profit-sharing too.

Invest in "new" Employee Benefits Producers?
(Please...)

Perhaps large fee-based P&C with tons of Risk Management expense has gotten so lucrative that you've decided to lay-down a series of bets where you live? If so, drop us a line. There's a lot of interest back here, on planet earth, if that works out.

<u>THE</u> CASE TO BE MADE:

The only case worth making is one that goes to the premiere issue in the Insurance Distribution System today... your independence and your *perpetuation*. How many times have you heard: "*Thank God for Personal Lines,"* this year? For the first time in my career, Personal Lines has become a perpetuation life-line and this topic needs to be on the Board's agenda!

It's called the *Great Recession* for a reason. As a result, your clients have declared war on every expense including your invoices. Some of you have seized the day and taken business from others less positioned. Many of you have fought to remain "flat". But, all of you have seen a drop in your agency's relative value. As a result, the older Producers who would otherwise be introducing their clients to younger stock-buying Producers in preparation for retirement are staying put. They're not retiring. They want those distributions and they've made it pretty darn clear that they will, indeed, make life miserable for you if you don't count their votes especially now, when Sub Chapter S pass-through income taxes need to be funded. That's what your profit-sharing lunch is all about.

In smaller firms it's a much quieter conversation, but it's the same conversation. That cash goes to fund flow-through taxes, buy a little love amongst the troops, perhaps a pittance for you (a' hum), and not much left to have the Treasury (Corp.) buy-back Ol' Joe's shares. Hiring a young Turk right now is conspicuously not on your "to-do" list either. If you don't call that a perpetuation doom loop, then you've embraced the term "external perpetuation".

HOUSE ACCOUNTS COUNT MORE THAN EVER!

Dedicating capital (cash) and resources (people) to grow Personal Lines prior to the *Great Recession* was at odds with perpetuation. I know that sounds stupid, but it's true. Dedicating resources into Personal Lines to grow high-return business is supposed to be a perpetuation good-thing. However, that cash and those people were needed to foster new stock buyers who skip Personal Lines boot camp so that they can build choking books of business which, in turn, means they can afford to buy your stock. The only agency stock a Personal Lines Producer can (ever) afford comes from "Dad" (Family held agencies).

Personal Lines Producers don't exist anymore but, if they did, you'd need four for every large P&C Producer in order to create enough income for those four to buy the equivalent amount of stock. You'd need four times as much time too, which is why you wouldn't dream of it (especially if you have my genes!). You'd go broke. It's just math. Your Personal Lines Carriers don't do that kind of math. That's what you do. In a way, you're to be commended when they bring it up from time to time. You're polite. You even feign interest in hiring a bunch of Personal Lines Producers. You'll even give it a' go occasionally knowing that, if the notion works out, you've got a new Producer ready to migrate to the big leagues, because they *must* migrate or the agency won't perpetuate internally!

Today's younger souls have fits trying to cover their stock payments each year. In some cases, you're covering them by applying odd-ball formulas (and strained logic) because many have overdrawn their run-rate salaries and <u>the last thing</u> you can afford is to have Ol' Joe fly-up from Palm Springs and get in your face because his re-payment check bounced! Actually, that can't really happen. You're backing Junior's payment because you are contractually obligated to back Junior! That's how it works. So, what... you're going to turn around and force Junior to sell-back his shares to the Corp because he's over extended? NO! Junior will be a second class citizen after that and you know it. You're better off shooting him (figure of speech), but *you can't shoot a shareholder simply because he/she can't make a payment!* You'll just send him/her home to tell his spouse that his salary/draw has been cut by 20% to repay the corporation for covering him/her this year and another 20% because "covering" him/her is a one-time event!

That's why you need to revisit "house accounts". <u>And that is the basis for juicing Personal Lines!</u> And, no... I didn't just contradict myself. You can grow Personal Lines by re-designing it so that an agent never migrates "up" and, in fact, never wants to. (We called them Career Agents in our shop.) But, that's not enough! You must also purchase personal lines revenue which means that you must prospect for it. If both initiatives work-out, you'll have enough cash for perpetuation options... to include hiring Commercial/Benefits Producers or funding "lift-outs" when possible.

THE BOARD WALK:

You begin. "Now onto the next Board item: Personal Lines." They're still listening so you continue, "We all agree that funding a new commercial Producer is on hold next year even if

Calamity Casualty comes through with that Producer loan, right?" They nod. "Biff (your sales manager) will have a sit-down with Dilbert and give him the 'you have three months or else' discussion. That means we have no Producer initiatives on the table for next year to offset the budgeted 4% loss you all ("Y'awl" if you're south of the Cumberland Trail) have projected. Well, I propose we do something new. Let's pull up the first PowerPoint slide:

1. **Retention Initiatives: Personal Lines**

Reduce the attrition rate to 97% at a cost of $30,000 (est.) cash-flowed by the increase in retention. That's four percentage points on our $800,000 book. That will keep us in the same profit-sharing level which is another $25,000 we won't make next year if we do nothing.

2. **Production: Personal Lines**

(Numbers appear) "We can't organically grow it as fast as we can buy it. We need to do both. These are the models Broker's Path provided showing a One-Year / Three Year scenario based upon acquiring a small $600,000 book. They plugged-in "What's his Name"... you know, that guy in the Bank Building who called me the other day. Anyway, the point is that small deals like that are slightly cash-flow negative in the first fourteen months... one year plus two months of lagging revenue and by year three they ring the register. But, the best part of these kinds of deals is that they give a nice lift to our stock price, almost immediately, because the evaluator will have to include it in his pro forma. As you can see, the impact is pretty sweet and Romain said we should do these deals on the "down-low"... something about Hedge Fund Managers finding out how we print money."

"The next slide is a model provided by Calamity Casualty. They'll cover the upfront cost of bringing-on dedicated Producers through some backdoor mathematics Broker's Path has been using. You can see the inclusion of Class B stock, non-voting, non-preferred stock..." (A Partner shouts "Dog Stock?") The laughter subsides. "Yes, you might call it Dog Stock. I think the term is phantom stock, but it's basically vested interest like we used years ago. It won't amount to much, but it saves us a pile of cash and we can, once and for all, keep good sales people in that line of work. Welcome to State Farm folks!"

"Finally, with Calamity Casualty's help, we've submitted a rating model to their Home Office actuaries. We're targeting youthful drivers...." (Groans fill the room) "Yes, yes, I know. But this model assumes that we will go after the cream of the crap, the kids with eighteen months of no activity and clean MVR's whose folks have newer cars and a house and the kids get a lot better grades than Biff ever did! We can pull Honor Roll data from the School District's website, target our message and save' em a butt-load over the Lizard or 'Flow' at Progressive." The concept is sort'a refreshing. We finally give

Personal Lines folks something to sell! And, we have a few more ideas on how to go after the lower loss ratio stuff too, because we're going after all of our Select customers in Personal Lines as well. There are ten times more of them than our standard accounts. If, for some reason, we do screw up their boat policy, we won't have to lock the balconies for fear a Producer might jump. That and our Select customers are squeezing the nickel until the buffalo... well, you know. They'll give us shot!

I Could Go On...

Yes, the numbers come on methodically, but they are worth more than other commissions you generate because they are so profitable and so sustainable. I have made the case that you will lose money on a $300,000 P&C Producer who's been at that level for several years. If you're helping that Producer buy stock, or worse, accruing him/her vested interest in his/her book, you're definitely in the hole!

Lay 600 personal lines accounts averaging $500 in commission alongside that P&C Producer (above) and it's not even close (or funny). At 6.5-times EBITDA (earnings) on those 40% margins your enterprise value increases $750,000. And, in the meantime, you're depositing $10,000 a month in your operating account! Maybe you only clear 30% because you've decided to fund Personal Lines Producers yourself and give them some "dog stock" along the way to keep them motivated. Go ahead! In that scenario you'll still have $8,500 a month in cash and $650,000 of enterprise value to play with! So, it takes five years for a Producer to generate 600 Personal Lines accounts (it does). Hire two! In the meantime, call around. Buy/merge smaller shops simultaneously using cash models or "Right of First Refusal" approaches we've developed. The combined effects are cash-flow neutral for a few years, but your stock evaluator will devote an entire paragraph to the wonderful "lift" it caused in your value!

I don't care if your Board can fit in a Smart Car or you have dozens of owners who all weigh-in. This is a Board Room discussion and we'd like a seat at that table. Call us. We know how to do this! We've done it!

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