Pathways Report

"Two Trains Leave the Station"

By
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"They say a fool and his money are soon parted.
Here's a list of some fools. Make it happen."

Greetings Agents and Brokers!

Recently, I was reminded of my days as a lad, chalk-boarding algorithms after school under the scornful eye of Sister Mary Nun-Chucks. And, though I can't really say that I pine for those days, I am grateful for the math skills she engrained into all of us uniformed souls fortunate enough to attend (and survive) *Our Lady of Perpetual Motion*. How was I to know that math would, indeed, be my salvation!

There is, however, an exception to the sanctity of math in agency operations: Personal Lines. The immutable laws of mathematics are suspended in that department.

Personal Lines seems to run entirely on its ability to blend into the woodwork; measured, if ever, by the lack of noise it creates. The only counting one does for Personal Lines is at year end when your partners count on a big fat distribution check.

Why is that?

And so, in keeping with our unconventional ways, we'll kick-off 2012 doing Personal Lines math. Yes, I know: delightful. (Reading math is even worse than doing it.) But, I promise that **you will never see Personal Lines from the same camera angle again!**

Before we begin, a word of caution is in order: math still sucks. Don't depend upon clever prose or an over-reaching summary at the end to excuse you from following along sequentially. You "Benefits" or "Risk Management" guys aren't relieved from this assignment either, because the reason we're doing Personal Lines math is so that *you* will get more of what you want. Yes… in an odd sort of way, this is, once again, all about *you*!

So, in deference to Sister Mary Penance, let's solve for "X":

> {f(x)= Personal Lines + Small Commercial @ 45% EBITDA x 6.85 multiple x PV adjustment – Minority Shareholder Discount +/- Balance Sheet} where "X" is the ex-factor in shareholder value.

Doesn't That Just Look Dreadful?!

I hope you enjoy!

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The first objection and drain on your patience is that Personal Lines just takes too damned long to grow so, why try? OK, fair enough. We concede Personal Lines *is* uninspiring and an irritatingly slow version of "small ball". You're to be complimented on your ability not to mention that when you're around your Personal Lines employees and carriers. Nice work!

We also concur that if a Personal Lines Producer displays "the gift of sales"- *Poof!* They're riding in the car pool lane with your best commercial Producer totally intoxicated (not literally, of course) with the allure of becoming just like him/her: a *real* Producer. Again, fair enough. A Personal Lines Producer measures success by putting an "EX" in front of that title. I get that too.

It's also written in scripture that an agency does best investing in Benefits and Commercial Lines Producers. It's practically Cannon Law. Personal Lines folks are great, and all, but they don't end-up buying a lot of agency stock or driving impressionable souls around in new BMW's while complaining about the Alternative Minimum Tax… point well taken.

Trust me. I truly do get the fact that the term: "Personal Lines Producer" may, in fact, be an oxymoron to many of you, as it was to me. (Note: "was" is a past tense verb.)

So, let's marinate all these well known facts with a mixture of bitter sweet math, shall we…

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Two Trains Leave the Station…

In a distracted moment, the Alpha Agency agrees to bring-on two Personal Lines Producers courtesy of Safeco's Producer Development Program (PDP). They weren't enamored with the idea at first but, eventually, Safeco's persistence and capabilities weighed on their ambivalence.

Six months, some agent schooling and fifty or so accounts later, both Producers are writing three auto-homeowner accounts a week, though some in their graduating class do twice that. Alpha's Producers could, too, if they were allowed to cheat and book agency re-writes under their codes as if that was new business. Not so, at Alpha, where Personal Lines Producers prospect the agency's Select business (small commercial) for cross sales and burn through a box of business cards every month.

After two years each Producer has roughly 275 A/HO accounts but, as we all know, the auto-to-home ratio isn't 1:1. Tweaking commissions towards auto lines is good math: reason enough not to do it. Another bad math technique is to use an "average" premium because New Jersey or the Gulf States don't pencil-out quite like rural Idaho. Still, we're using a $1,000 premium for an HO-3 because we forgot what's so special about an HO-5. We're using $900 every six months for multi-car auto, because that feels like a good number most everywhere except Montana, where MKGRD's apply (Moose Killer Grill-Rack Discounts). We'll calculate auto commissions at 13.9% because the insurance gods have taught us that a portion of new biz goes to 10% markets. Combined, the "average account" generates $390 in revenue.

At the end of two years, these two fine Producers have built-up $215,000 in run rate revenue, combined. There's a problem with that number because it ignores account run-off (attrition) over those two years. But, as problems go, that's not a big one. After all, we're talking Personal Lines, right?! We also assume that they hit their stride around the six month. Maybe that's true. Maybe it's not. There are other variables, one might want to consider, if poking holes in our math is the objective:

- ✓ Annualizing revenues ignores the 2½ month lag when Alpha actually gets paid.
- ✓ Contingent income isn't included. (Not to mention the carrier trips you qualify for!)
- ✓ Overall agency account retention goes up with two able bodied Producers to help "save" accounts ready to leave. We're ignoring that too.
- ✓ We're also ignoring the fact that some folks just don't pan-out.

Tell you what… Let's knock that $215,000 number down to $200,000 because the minuses look a little bigger than the plusses (above). Let's use $200,000 in revenue, instead.

Finally, at the risk of losing (the rest of) you, assume each producer was hired at $40,000. Alpha increased that number to $42,500 in year two. Both Producers received $3,000 bonuses, each year. (Alpha still calls them "Christmas Bonuses," which is nice.) Toss in cheap E&O, paid out of pocket, plus all the selling, education, administration, and Health Benefits expenses. Add-in 2% for CSU expense on that $750,000 of premium ($15,000) they produced, cell phones, parking permits… the works. **Guess what? Alpha spent $200,000 in two years to generate $200,000! What a joke! You were right! The numbers don't pan-out!**

Thankfully, these two Producers weren't all too happy with $45,500 plus all the policies they could eat. They wanted (demanded) a car allowance and an explanation as to why Alpha's President went to Maui with Safeco last year and not them. Eventually, both appeared in the President's office and voiced their concerns. Those voices eventually grew so loud that they were both shown the door.

Alpha's little adventure didn't turn out, did it?

The Other Train Leaves the Station…

The guys at the Beta Agency weren't dopes like the Alpha guys were. They brought-in young Turk; got him licensed and offered to pay Biff, their Sales Manager, a little extra if he mentored the "Yute".

At first, Turk cut his teeth writing call-ins in the Select Department. Eventually, he wandered into a few Tavern accounts (naturally), claiming he found a "program" that was competitive. As it turned out, it was. By the end of the first year, and with a few choice referrals from Beta's President, Turk posted $50,000 in commission (written, not earned) which is a pretty smoke'n number. He booked $100,000 in year two which, as we all know, is ridiculous and, thus, probably not true even though his new business log claims otherwise.

Eventually, Biff lost track of Turk's activities and left him to fend for himself. And, why not? $100,000 in new biz in year two is pretty good! By the end of that second year, a few house accounts had come-up for reassignment because they had outgrown the Select department. The President wondered if Turk was the worthy recipient, so he asked his Controller, who believes that no one is truly worthy, what he thought.

Though Turk had generated $150,000 in new business, the actual dollars-in-the door came closer to $110,000 at the end of year two. The "lag" was one issue. The fact that some of those hairball accounts he wrote cancelled for non-payment was another. Given Turk's $60,000 salary, car allowance, cell phone, education expenses and T&E's; the Controller's math on Turk looks pretty dim. "We're still underwater," the Controller sighs as he briefs Beta's President who sagely responds: "It takes several years to vest a Producer. Turk's on track. Let's cede him those accounts next year."

Beta's President planned on pulling Turk aside at the Christmas party to relay the good news. But, that was before Turk got a little "in his cups" at the event and started bad mouthing about what cheap (insert letters) Beta's owners are. That didn't sit so well with the partners when Turk's remarks became known.

Alas, another Beta male drop-kicked through the goal posts of life…

But, our story doesn't end there because the Beta Agency is "stuck" with $110,000 of revenue that needs some attention. They'll have to pay someone in "Select" to service that business. The irony that Beta will actually pay an agent to spend time in taverns isn't lost on Beta's partners, either.

Turk did produce a few nice accounts which Biff took the liberty of assigning to himself. Biff will get paid on those. In all, the expense on Turk's business wasn't all that that high. The problem is that Turk's business just won't stick. That's another Cannon Law of new Commercial Producers who leave before they validate. Their hairball accounts do, too. Though that's not always the case, it's pretty much true. Good accounts seem to materialize in a Producer's book after they've burned through a couple of years.

Back at the Alpha agency, their President offered $2,000 to each of his four Personal Lines Account Managers to hold onto the business his dearly departed Personal Lines Producers dragged in. Safeco's CSU did a fine job, as well. They sent some letters and did a few refrigerator magnet campaigns. Whatever else they did, it seemed to do the trick. Most of the biz stuck.

Alpha Agency had $200,000 of run-rate revenue the day they showed their two Producers the door. After some bonuses, maybe a few raises along the way, they'll spend another $15,000 servicing those customers. Safeco's CSU will cost an additional $15,000. Beta will probably get a nice contingency bonus, but let's assume someone T-boned their loss ratio and they don't. Next year, the revenue normalizes around $175,000 after the ex-Producer's families and friends broker their policies elsewhere.

By any mathematical denial mechanism one could employ, Alpha agency's pre-tax goes up $145,000+/- (probably more: fewer AMS/Applied users and higher contingencies). They have little to no debt after this adventure.

Here's the deal…

This Personal Lines fiasco increased the agency's EBITDA (Earnings before accounting terms you couldn't care less about) by some number, even the most cynical reader would concede, in the $150,000 range. Remember, we got to this number by assuming a Personal Lines Producer could write one auto and one homeowner policy every other day. The phone still rings, right? That's not a stretch especially since we sent those Producers out to deliver Select renewals for the purpose of cross selling Personal Lines.

At the end of the year, Alpha Agency's stock evaluator will gladly multiply $150,000 by 6.5 +/- "times". That's the going number agency evaluators' use. If you're not all that hip on how agencies are valuated, just assume I know what I'm talking about or, alternatively, that I'm making it up.

Multiplying $150,000 by 6.5 is easy. From that number, we subtract 15% because internally traded agency stock is valued less than if Alpha had sold the joint to some mean spirited outfit who would squeeze expenses.

The net result is that Alpha's value grew $825,000! Seriously, I'm not making that up. The kicker is that Alpha's owners will have $150,000+/- to distribute at year end, in addition to the increased value until the earth cools.

Two Producers- Safeco trained and mentored; generated some number around $825,000 in agency enterprise value without so much as a questionable expense account... Just imagine if those Producers had actually worked out!

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Let the math sink in. It's real.

Now, I'm going to ask you to imagine investing $200,000 (total costs for two Producers for two years plus all related expenses) at a burn rate of $8,350 per month. At the end of two years, those investments (expenses) stop in our example. Suppose I told you that, in the following

year, you'll net $13,500 a month for a very long time (after all expenses and assuming 88% account retention). Is there anything you do or invest in that poops that much cash?
Some agencies might even qualify for Producer loan assistance, like the old days. If so, the pre-tax rate of return is 400% in two years ($200,000 expense against $800,000 in equity growth). Your ROI is *ever so slightly higher* if the carrier forgives the loan because you met certain production thresholds. {See: "Found Money" in Wikipedia.} Oh, and in case that's not disturbing enough, the value of your agency went up, tax-deferred.

To be certain, the value of the Beta Agency will increase, as well. The only problem is: sustainability. If a Producer doesn't vest, the agency's value doesn't really change. If he/she does make it, the agency's value grows, but more slowly because that person needs to pull-out around 60% of their book once they start buying stock (30% +/- commission split + T&E + Stock Distributions + Education, etc comes to 60% when that Producer is really rolling). {Read: Perpetuation 102 on our website.}

Now, this is where the Commercial and Benefits folks need to perk-up. Not every new, prime time Producer makes it. Funding those investments takes cash and patience in equal proportions. Done correctly, Personal Lines production can fund your new Commercial and Benefits Producers and/or "buying" existing ones in your area. It can fund smaller bolt-on agency purchases and/or cover the cost of claims and risk management services needed to drive large, consultative clients to your firm. It can also lessen the pain when Producers don't pan-out. By driving higher stock values, it also allows you to dilute (issue) shares to the youth with less pain.

Moreover, by marrying Personal Lines to Select (SBU: small Commercial and small Benefits) those Producers will hone their skills talking to Commercial/Benefits clients when delivering BOP's with the intent of cross-selling Personal Lines. That's what we did and we simply printed money and minted the next generation of Commercial and Benefits Producers who, in turn, bellied-up to the bar and ordered several rounds of stock over time.

The results are:

1. We organically grew Personal Lines 10% a year and that's a ton for a firm our size.
2. Our Contingents grew dramatically and, more importantly, *dependably!*

3. The cash generated from large Personal Lines contingencies helped us meet our cash obligations necessitated by yearend Sub Chapter-S distributions. We actually had the cash our P&L said we had (OK, most of that cash, anyway) because Personal Lines commissions hit the operating account faster than other lines.
4. At 45% margins from Personal Lines (after CSU expense!) we applied the excess cash to growing our Commercial and Benefits practices which, in turn, created able stock buyers and offset the soft market pressures on our revenues.
5. All of which drove our stock price higher which:
    a. Motivated the youth to buy more and buy it early so that they could enjoy the gains and the growing distributions.
    b. Motivated the old farts to dilute the share price by issuing more shares to the youth because our stock was growing rapidly thereby offsetting the dilution effect many times over.

Just So That We Are Clear…

In our example, $150,000 of "pre-tax" is distributed to Alpha Agency owners on 12/31 (though we all know that doesn't happen in December). Most of you (60%) are S-Corps owned by two or more owners. So, let's assume two owners. Each Alpha Agency owner will receive $75,000 cash on this "failed" investment.

Think about that for a moment.

An investment, which might be funded by others (carriers), that ends up paying "you" $150,000 gross, annually, for the foreseeable future, creates a dilemma. You can certainly take your share of that money home each year, pay upwards to 50% tax on it and then reinvest what's left into 10-year T-Bills yielding 2.7%, which is nice, I guess. That comes to $1,600 a year. That's not a lot. But, alas, you'll be taxed on that $1,600 gain, too, at the capital gains rate of 15% plus state and local. Still, that's an option.

Option two might be to hire-back those two Personal Lines Producers. Give them a nice raise, pay all the overhead expenses and "break even" on that same $150,000. That's right, forego the cash! Then, ask a carrier to find you two more Producers that they might just help you fund. Now you've got four! If you never took a penny from the carrier that $150,000 investment actually looks like an investment yielding 400% *tax deferred*.

So, here's the end of--chapter math quiz.

Question #1)
One of these two numbers is bigger than the other one:

2.7% (T-Bill before tax) **or 400%** (assumes no loan)

Question #2) Select one:
Alpha agency owners could pull out the money each year and earn fifty three dollars a month after-tax investing in 10-year Treasuries Notes and ignore the fact that they can't touch that $75,000 for ten years and, when they do, the value of those dollars will be worth a lot less in the year 2022.

Or

They can <u>each</u> add another $400,000 in owner's equity ($800,000 / 2) over the next <u>*two years*</u>.

Math sucks, doesn't it!

Common knowledge, right?

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