Banks and P&C Insurance Agencies: A Reality Check.

By Chris Burand

Do bank stockholders benefit from acquisitions of P&C insurance agencies? The answer? Yes, IF... one, appropriate due diligence is completed and two, perfect implementation occurs and three, the price paid is set according to reasonable expectations (and expectations should be given a good reality check). If these three conditions come together, then, as so many players seem to expect, banks can make fantastic returns by acquiring P&C insurance agencies. So far though, results strongly suggest these conditions rarely (if ever) occur simultaneously.

Due Diligence

Three types of due diligence are required: financial, legal, and operational. Most banks are very aware of financial and legal due diligence so I will not describe them here. I am not suggesting either should be ignored or minimized. Most banks though already understand financial and legal due diligence, so I will not belabor the point.

Operational due diligence

Operational due diligence is rarely given adequate consideration and is frequently ignored. Operational due diligence includes peer review/bench marking, competition, employees and their skills, and most important, the variations in culture between banks and insurance agencies.

Peer review/bench marking

Peer review/bench marking helps align expectations with reality. Expectations, such as unrealistic hopes for economies of scale, are often set too high. For example, a large bank asked if I thought they could get an extra percentage point of revenue from insurance companies by bringing their size to bear in negotiations. I replied, "Yes, but you will inevitably lose that point through extra expenses." They did not hear anything past "Yes." If they had, they would have carefully considered my analysis of large broker results that show an average five-year pretax profit margin of approximately 10% (that average then decreased to 8% before hard market conditions in commercial lines started to add some points to the bottom line). [Note: these increases are expected to continue for one to two years at the most.] The 10% profit margin closely matches independent agency profit margins which, when adjusted for owner bonuses (to minimize taxes), easily equal 10%. (All major industry benchmarks show independent agency profit margins, even after owner bonuses, average 5%-8%. If adjusted for owner perks and bonuses, pretax profit margins would equal at least 10%.) Therefore, even the larger brokers show no sign of having gained any sustainable economies of scale. According to Bain and Company, "...narrower focus and concentration of resources on a single core business, rather than proliferation of investments in hot markets, proved the most frequent road to sustained, profitable growth."[1]

[1] *Profit from the Core*, Chris Zook with James Allen, Bain & Company, Inc., 2001

If a large entity makes more, it is because they are better managed, not because they are large. So did this bank make that extra profit point? No. Instead it has made a series of disappointing announcements regarding insurance sales and profits and has reorganized at least twice in less than twenty-four months.

An article in the January 27, 2001 issue of *The Economist* further expanded on the lack of economies of scale. The article stated, "The record of most other banks that have pursued Mr. McColl's [Chairman of Bank of America] strategy [of acquiring lots of banks] strongly suggests that beyond a certain size any economies of scale in operations are easily outweighed by diseconomies in management and, especially by the need to pay over the odds to strike a deal in the first place."

Another reason peer review/bench marking is an important aspect of due diligence is it enables the acquiring bank to know whether or not its acquisition target is well run. Buying an agency that under-performs its peers without realizing it is a painful mistake many banks have made. The situation is made worse if the bank does not have a remedial plan to fix the agency. For example, if due diligence reveals an agency has poor growth and poorly performing producers (less than $250,000-$300,000 commission each), the bank must realize the producers will not be magically transformed because a bank provides thousands of warm leads. The lack of leads is never a legitimate reason for a producer's poor performance (no matter the size or nature of the marketplace) and such producers will never be successful just because someone starts providing them leads. A more comprehensive plan is required to remedy the situation.

Peer review is important too because many agency owners do not realize just how poorly their agency is performing. If the buyer just depends on the seller's perspective or their conversations with the producers, they will never realize the problems they are buying. This is especially true of many small agencies which are favorite targets of community banks.

Competition

Similar to peer review, a buyer should assess what the acquisition target's competition is doing. This involves more than determining what other banks and agencies are currently doing. It also includes considering what they will do in response to the acquisition.

For example, *The Economist* wrote in its January 27, 2001 issue every time Bank of America would make an acquisition, a particular competitor would open a nearby branch to capture all the newly acquired firm's disaffected customers! They knew the acquisition would result in upset customers and they wanted to present a warm, welcome, and readily available solution. They succeeded.

Many agencies have discovered that clients of recently acquired agencies (especially those acquired by banks) are easy pickings. As one agency principal said of his long time number one competitor, "The ... bank's acquisition of ... was the best thing that ever happened to us in two ways. First, we no longer have to compete with them for the best new accounts. We get those accounts now 100% of the time rather than 50% of the time. Second, they have become a fantastic source of new business. Their clients leave voluntarily and/or we sell them on leaving. Selling them on leaving is easier now that the bank owns them."

Carefully assess all competitors because no matter how meager they may seem, sometimes the best way to get an inert business moving again is to scare them into action and a bank's acquisition of an agency may be the fright they need.

Employees and Their Skills

Insurance is always, first and foremost, a personal relationship business. When buying an insurance agency, an acquirer is buying renewal commission revenue that will last for *x* years and, hopefully, the sales and service people with the ability to keep those renewal commissions while also generating new commissions.

What types of sales and service skills are coming with the deal? First, think about the agency owner(s). Are each of them key to sales and/or management? The answer, 90% of the time, is "Yes, very much so." Even if they are not actively selling new accounts, they still have the relationships. An important consideration, then, is why they are thinking about selling their agency and are all the owners on the same page regarding this decision?

Consider for a moment what the average owner gets by selling. According to an article in the *National Underwriter*, Mr. Gerald Vigneron, managing director of North Bridge Advisors, Inc., stated that banks are paying typically two times annual commissions for agencies with $500,000 to $1,000,000 in commissions. Agencies with between $500,000 and $1.75 million revenue average $511,251[2] revenue per owner. If they sell for 2.0 times revenue (not commission, so this is a very high-end price), they make $1,038,604 each. They currently earn an average $146,642 in compensation and profits (excluding benefits and perks), so they only make 7.08 years' salary. If they sell stock (rather than assets thereby resulting in a lower tax rate on the sale), the tax savings equals another 1.6 years' salary. Adding back in benefits and perks at a conservative estimate of 5% of revenues, the sales price per owner/annual compensation plus profits ratio drops to 5.3 years.

Good salespeople are born risk takers. Why would they sell for five years' salary if they still plan to work hard? They probably would not sell unless they have specific concerns. Perhaps they think the agency will otherwise fail (which the prospective buyer would hopefully uncover through due diligence). Or maybe they want to retire quickly (then where is their future motivation?). Or perhaps their fears are caused by a loss of confidence, particularly with the insurance marketplace changing so dramatically. If this is the case, then the new management must help the owner regain their confidence because

[2] *GPS Study*, APIS, 2000

without it, the salesperson will not successfully sell and the growth predicated by the purchase price will not materialize.

Also, consider the nonowner producers. As mentioned earlier, unless an experienced producer has at *least* $250,000, the acquirer probably cannot count on the producer to grow the agency no matter how many leads they are given. As a result, the acquirer must rebuild the sales force from the ground up. Does your bank have the skill to develop a successful insurance sales force from ground zero?

Another skill set is technical. Technical skills are becoming more critical because insurance companies have lost so many people with good technical expertise. This places more burden on insurance agency personnel. For banks selling insurance, this is especially important. Suppose the insurance agency does not or cannot (in this tough marketplace) offer adequate coverage to a commercial client with whom the bank has a loan. The client has a claim and declares bankruptcy and/or sues the agency/bank for E&O. If bankrupt, the bank finds itself with a loan that it caused to go bad. Based on the hundreds of agencies I have visited, I estimate 90+% of all customers have never even been offered the coverages they need, much less have they purchased the coverages they need. When buying an agency, make sure the employees have the technical skills required to keep your clients solvent.

Culture

Cultural differences are key reasons why most of all types of acquisitions fail. This is because the buyer's expectations, and therefore the price they pay, are usually based on how the buyer relates to their employees and customers and how the buyer expects customers and employees to react to the inevitable changes. Reactions and expectations are rarely as anticipated.

I worked for Cigna Insurance after INA's infamous acquisition of "little" Aetna. Even ten years after the merger, INA people sat apart from "little" Aetna people in many company lunchrooms. The epitome of their cultural differences was summed up by one person who said, ""Little" Aetna people know wine. INA people don't." Do you think these people were as productive as they would have been if such significant cultural issues did not exist?

Cultural differences between banks and insurance agencies are often extremely significant. One of the more obvious differences is compensation. Some consultants and bankers believe they can buy an agency and make money by slashing agency staff wages to those of bank tellers. This is a huge cultural issue because agency CSRs generally require more skills and professional training than bank tellers so they should be paid more. I know an agency/bank manager that does not believe this and pays accordingly. He has great profit margins and a constantly declining customer count. By paying low, his profits are high but he does not pay enough to retain quality employees. At his current pace, he will run out of customers within four years.

Insurance agencies are sales organizations. At the heart of every agency is the producer and his or her service staff. The producer's and support personnel's sales spirit is the pulse that keeps an agency alive. An easy way to crush that spirit is to limit what the producers can make. Many banks have made the mistake of capping producer compensation so that the producers do not make more than the bank president. This is a key cultural issue because in insurance agencies, the importance and nature of the producer is implicitly understood and no room exists for satisfying the president's ego by making him or her the highest paid person. Without good producers and adequate service and support staffs, no agency exists.

Another cultural difference is that insurance must be SOLD. People go to auto dealerships wanting to buy a car. People go to Dell's web site wanting to buy a laptop. People go to banks wanting a loan. People do not go to insurance agencies wanting to buy insurance. The only reason people buy insurance is because they have to, not because they want to. Insurance is the only product/service people ever buy and hope they do not use. Insurance is the only product where a person pays and gets nothing except a piece of paper unless they suffer some loss first. It is like hiring an attorney in a frivolous lawsuit. We hate paying the attorney, we gain nothing from it, we still lose, and our only goal is to minimize our loss. This is why insurance must be sold.

Good salespeople, the only kind to have, are loose cannons. They always do things their own way, to one extent or another. ***Crush that spirit and sales will vanish or diminish significantly.*** Good salespeople are required because, again, insurance must be sold. Of the thousands of insurance salespeople I have met, complacent producers always produce complacent sales.

Explaining a sales culture and its importance to people who have not personally experienced it is difficult. The tendency is to think, "I understand and can do that." Saying is easier than doing. For example, a few years ago a regional bank, Hibernia acquired a large regional agency, Rosenthal. By all measures of which I am aware (and I have no inside information), Rosenthal was an exceptionally good agency. The grapevine says Hibernia paid two times revenue, mostly cash, for this very strong agency who had a very strong culture. According to a press release recently issued by a new Hibernia manager, the results are not promising. It does not sound like the bank was able to maintain, much less capitalize on that strong sales culture (and hence the new manager was hired).

Recent studies prove indeed banks are having a difficult time maintaining the sales culture they are buying. According to a study by Marsh-Berry appearing in *Best Week* February 26, 2001, bank owned agencies were only growing by .3% versus the industry average of 5.2%. Also, their EBIDTA was only 67% of industry average. In other words, bank owned insurance agencies are writing less business less profitably. The mismatch of cultures most often leads to worse results rather than better results.

These results are not to say that banks cannot do well after acquiring an agency. It is necessary though for both parties to recognize the significant cultural differences and if both parties are to maintain their strengths post acquisition, the cultural differences probably cannot be and should not be eliminated. For the greatest success, the post acquisition plan must build on the cultures of both agency and bank.

Perfect Implementation

The three keys to perfect implementation are:

1. Set reasonable and realistic expectations (see below).

2. Realize each deal is different. Cookie cutter approaches do not work. No matter how many times the acquirer has acquired, each seller is different.

3. Create a detailed assimilation plan with provisions to change the plan at least every six months.

If the buyer does adequate due diligence and follows these three steps, they will likely merge the two corporations successfully. I strongly believe good due diligence will lead to reasonable expectations and will uncover the unique aspects of the specific deal. This in turn will lead to a detailed and comprehensive assimilation plan. To suggest any specific assimilation plan or strategy will succeed without completing Steps 1 & 2, as so many financial experts believe is like putting the cart before the horse. Not only will the cart not move much, it will get run over.

Reasonable Expectations vs. Purchase Price

The desire to acquire is often fueled by grand expectations. Cross-selling, high profit margins, and investment opportunities are a few common areas where expectations often exceed reality.

Cross-Selling

Grand allusions of life made easy by great cross-selling opportunities are hard to resist. Consider the following true stories:

- A bank proposed buying an agency in a rural area. The success of the acquisition was based on the assumption they would succeed in cross-selling a percentage of their banking clients with insurance services and a percentage of their insurance clients with bank services. They carefully analyzed the number of non-mutual clients they expected to cross-sell and the new clients the combined entity would gain. The bank carefully studied the numbers and saw a promising future. Unfortunately, they never added these estimates to their existing client base. Additionally, they completely ignored due diligence on their competition. If they had added together the number of existing insurance clients, the number they expected to cross-sell, and their growth estimate, they would have discovered that they expected a total market share exceeding 30% of the population. Considering eight other agents were vying for the same business, 30% market share just is not feasible. The bank never examined the total picture to learn if their expectations were reasonable.

- A community bank of long standing in a small town proposed buying a long-standing insurance agency in the same town to capitalize on the cross-sell opportunities. The appeal of cross selling is that, hypothetically, the cost of selling a current client a second product cost less because the relationship has already been established and therefore the barriers to the sale are less. When both entities are community oriented with long histories in a small town, just how important is the cross-sell opportunity gained by buying an insurance agency? Why will buying an agency provide any advantage to making a loan to a new customer? After all, if the bank has been in town for a long time, haven't they had ample opportunity to solicit everyone in town already? If the insurance agency has been in town for a long time, haven't they had ample opportunity to solicit everyone in town too? No economies of scale are gained. The producer still has to send a letter, make a phone call, and visit the prospect regardless of whether the bank owns the agency or not.

- Sometimes the bank and/or the agency thinks that once their acquisition/merger/joint venture is complete, customers will choose their services and no extra work will be required. Stop and think about this. Why? Why would a customer choose to do business with the bank just because it now owns the agency through which he or she has been buying insurance? No natural inclination exists for insurance agency customers to buy banking services. If they did not buy from the bank before, why would they buy from it now?

- According to *The Middleton Letter*[3], BB&T, one of the nation's largest bank insurance agencies (and oldest having been selling insurance for 75 years), still only has a 5% penetration of bank customers. If leads alone, or size alone, were enough, then they should have sold more than 5% of their customers.

These three stories are all very typical of banks' expectations and many bankers' and agents' expectations are even higher. These high expectations are one reason bankers have been willing to pay such high premiums for agencies. According to Marsh-Berry & Co., Inc.'s 2001 data, the average EBITDA multiple paid by banks upon first expansion was 8.01 which is much higher than the 5.53 average paid by privately held agencies.[4]

Buying an agency and expecting cross-selling to be the growth engine that pays huge dividends is a mistake. One reason cross-selling is so difficult is loan officers and insurance producers do not want to risk another department ruining their relationships. People value the chance of a loss, like the potential loss of a customer, at twice value of gaining something new, like a new customer. As the old saying goes, "A bird in hand is worth two in the bush." Therefore, if a bank is depending on harvesting existing relationships, it must make sure current customer satisfaction is strong within the bank and the agency. Here are a few actions taken by banks that own insurance agencies (from Robert Heady's April 2002 column, published in the *Denver Post*):

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[3]*The Middleton Letter*, March 2002

[4]*Business Insurance*, March 4, 2002

- A $9 finance charge for being $.11 short on a credit-card payment.

- A $35 charge for receiving and depositing a check, written by someone else, that bounced rather than charging the person who wrote the bad check.

- Raising credit card interest rates from 23.99% (which many people already consider usurious in reality if not in name) to 28.99% without prior notice.

- Requesting a "paid-in full" release for a mortgage more than four times and never receiving one.

- Not acting on the request of an estate administrator, though the person was entirely within their legal rights to make their requests, without the administrator having to involve an attorney.

Insurance has a bad enough name and incurring such ridiculously bad customer service definitely does not improve an insurance producer's desire to cross-sell nor does it improve a customer's desire to buy additional banking products (on an additional note related to cultural differences, 99% of all agents would write-off the above-mentioned finance charges and all producers I have ever met would be insulted, embarrassed, and angry if their insurance customers received such charges from the bank definitely making them resistant to referring any future customers). One might hope these are exceptions but too often they are not. We all like to think we offer good, even great, customer service but few corporations can prove it because few corporations actually ask their customers' opinions. Even such notoriously poor customer service companies such as airlines think they provide good service. One airline, Southwest, has had great service ratings for years even though they do not provide two items many airlines consider key to providing good customer service: preassigned seating and food. Instead, Southwest serves peanuts and their customers describe the loading process as being loaded like cattle. Yet when airline customers are asked which airline provides great service, Southwest gets top billing. The other airlines just don't get "it."

Southwest's excellence continually pays off. After 9-11-01, they actually reported a profit and they were the only large airline to not lay off employees. Their customers sent them cash, voluntarily, just to keep them flying (*Texas Monthly*, February 2002). Since the insurance industry was hurt by 9-11-01 too, are your customers sending you twenty dollar bills just to make sure you stay in business? Since banks have been hurt by the poor economy, have your customers sent you cold cash just to make sure you stay in business?

My personal experience with banks suggests they fall short of the customer service they advertise. Not long ago my former bank failed to notify me they had canceled my ATM card due to a software glitch. I found out several thousand miles away while on vacation. I had fully expected to be able to get cash as needed, when low and behold, my ATM card would not work, leaving me stranded without cash in another country. This same bank has recently purchased a large insurance agency and by their own admission, they have achieved extremely little success (Go figure!).

High Profit Margins

Many buyers are basing deals on forecasts of 25%, and higher, pro forma profit margins. This is dangerous. In fact, the SEC recently released a warning to investors regarding companies that report or stress pro forma earnings because they are so often overly optimistic.

Consider too that not only do Wall Street sharks mislead using pro forma and EBITDA statements, buyers often mislead themselves. For example, think of all deals done based on EBITDA profits that will never be realized since they contain too many rosy assumptions. As mentioned earlier, synergies do not exist and therefore basing a deal on an EBITDA which assumes synergies only causes disappointment.

Consider the following, less optimistic deal. A $1,000,000 insurance agency, 20% EBITDA, and an EBITDA multiple of 8.0, translates to a 1.6 times revenue price or $1,600,000. At a 20% margin and 7% growth, *the bank will not breakeven for between ten and twelve years*. *Additionally, the probability of achieving both a 20% profit margin and 7% growth is near 0%.* Bain & Company completed a study of 1,854 companies and found that only 13% achieved real annual growth of 5.5% and earned the company's cost of capital over ten years. They also found that 99% "of management teams will fail to meet shareholder expectations." Shareholder disappointment is likely because the P&C industry has averaged nominal growth of only 4%-5% the last five years (agencies are growing slightly faster due to consolidation) and as mentioned earlier, profit margins even in the biggest and most professionally run brokerages are currently only 10%.

Investment Opportunities

Some experts would advise that such calculations underestimate the investment return because at the end of ten or twelve years, the agency can be sold returning additional capital. This is true if the agency is run well during those dozen years. Given the number of banks that have sold agencies for pennies on the dollar after learning the insurance business was much more difficult than expected, I would not recommend counting on selling the agency for a significant sum.

Other experts state that buying an insurance agency presents an arbitrage opportunity because banks' P/E ratios are higher than agencies and therefore a bank can buy an agency and immediately have the agency's earnings repriced at the bank's P/E ratio. An arbitrage opportunity is definitely possible if the market does not realize and adjust for the less valuable cash flows of an insurance agency. If the market acts efficiently, a weighted average P/E ratio will result.

Other experts recommend using the bank's stock for acquisitions since stock does not result in cash outlays. It does dilute the current stockholders' value though. Additionally, most acquisitions result in the acquirer's stock price taking an immediate hit (slightly more than 2% +- the day before the acquisition[5]) so while it looks good on the income statement, the bank's stockholders are still injured. Moreover, using stock and saying it has no effect just because it does not affect the income statement is too simple. This is similar to Warren Buffett's famous comment about stock options. To paraphrase, "If they're compensation but not an expense, what are they?"

The Attraction

With all these problems and such poor results, why are so many banks buying so many insurance agencies? Sometimes the grass is simply greener on the other side of the fence. Other times, herd mentality is just too hard to resist. Everyone sees everyone else buying agencies so they think they must buy one (or many) too.

Another reason is the "buzz" about easy success is too enticing. Beware of any banker talking about the success they are having owning an agency. Considerable bragging occurs and you can always tell a bragger when they talk about how big they are, how much in assets they have, or how high their sales are. These are all mostly meaningless numbers because how many assets someone has is pointless without knowing their liabilities. Huge sales are meaningless without knowing the profit margin. High growth is useless if it is not profitable growth. After all, anyone can buy growth. To make my point, consider that Enron was the fifth largest corporation in the Fortune 500[6] last year—measured by assets.

Another reason for the buying frenzy is that many consultants and investment bankers are painting very rosy pictures of these acquisitions. Their audience wants to hear how they can make a lot of money and for significant fees, many consultants and investment bankers are more than willing to tell them what they want to hear.

To fuel the fire, many agents and bankers looking for a deal often ask the wrong question. They ask, "Can you help me do a deal?" The easy answer is of course, "Yes." The more appropriate question though is "Should I make this deal?" or "Using realistic projections, will this deal make us as much as we need it to make?" A J.P. Morgan advertisement from the late 1980's summed it well, "What does finding the right price mean if it isn't the right thing to do? In mergers and acquisitions, failing to make the distinction between price and value is like turning your back on reality."[7]

Define Success

Many banks are looking for business models employed by other banks that have *successfully* entered the insurance agency business. Their strategy of copying a successful peer makes sense. Unfortunately, the definition of "success entering the insurance agency business" is not clear. The connotation is that

[5] *The Synergy Trap*, Mark L. Sirower, The Free Press, 1997

[6] Fortune Web site

[7] *The Synergy Trap*, Mark L. Sirower, The Free Press, 1997

success has been achieved by many entities but at what have they succeeded? By all measures the majority have failed. As mentioned, BB&T, hailed as the most successful, still has very minimal cross-sell penetration.

Do not be confused by a bank's or any other acquirer's success at buying an agency, or especially many agencies, as a sign of success. It is easy to do a lot of acquisitions and hide the poor results for many years (consider Tyco, WorldCom, etc.). For some reason in our business culture, the connotation is that if an entity is buying another entity, the buyer must be quite successful when the opposite is undeniably the case in most acquisitions. The seller almost always gets the better deal. Therefore, I recommend copying those entities that have achieved organic growth of 10%+ and pretax (not pro forma or EBITDA) profits of 15%+.

The Bottom Line

The initial reaction to much of this article may be to reject it. Too many other people who are in business to sell insurance agencies are saying different. Listen carefully though and discern the difference between actual results realized and results promised and the difference between actual profits and pro forma profits. These differences are key. I recently reviewed a buyer's financials and their EBITDA was almost 10%, yet their cash flow was inadequate to pay their operating expenses much less make principal payments.

Be careful of the context in which results are reported. For example, consider the difference between BB&T's seemingly wonderful results and consider those results relative to the number of acquisitions required to get there, the size of their bank relative to their commissions, and their poor market penetration of their own customers. Relative to their potential, it sure does not seem they have succeeded in the insurance business.

Success is feasible but it takes a lot of preparation and hard work, better due diligence, great implementation, reasonable expectations, and a reconciliation of whether achieving those expectations will be sufficient for the bank's stockholders' best interest.

NOTE: None of the materials in this article should be construed as offering legal advice, and the specific advice of legal counsel is recommended before acting on any matter discussed in this article. Regulated individuals/entities should also ensure that they comply with all applicable laws, rules, and regulations.

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