Is Big Really Better?
By Chris Burand

How big does an agency need to be to prosper and be safe from extinction? Small shops (with less than $500,000 in revenue) undoubtedly must grow (excluding some specialty and non-standard auto agencies). These small agencies have books of business too small for companies to make a profit. Given companies' recent loss ratios, many companies probably cannot breakeven on anything less than $250,000, and they may even require as much as $500,000, premium. Some may argue small agencies make up for their lack of size with quality, i.e. loss ratios. This may be true in some cases, but not overall. Besides, companies are interested in volume first, underwriting profit second. To satisfy companies' hungers, agencies need a minimum of $1 million written premium with their top standard lines companies (maybe less for local regionals).

At the other extreme, dozens, maybe even a hundred or so agencies, brokers, and banks are trying to grow really huge as fast as possible. One or two might succeed but most will fail. They will fail because most of their growth is being obtained through acquisitions and most acquisitions fail to earn the buyer an adequate rate of return. Every study I have seen for the last 25 years has shown the vast majority of acquisitions fail in this regard.

Most of these major acquirers of insurance agencies are effectively consolidators. Consolidators are quite common in many industries and as in other industries, insurance agency consolidators (including many banks) are paying sky high prices and driving the market for agency sales. They are able to pay high prices because their stock prices are high and their stock price is high because the market believes these consolidators can achieve higher profit margins by generating greater efficiencies, negotiating higher commissions from companies, implementing professional management, and so forth. A consolidator typically buys many agencies in an ever expanding and rapid fashion so growth remains high. By doing so, new revenues get booked before expenses creating the impression they are achieving higher profits through efficiencies, higher company compensation, and better management.

The consolidator's stock price is always under severe pressure to grow so they are willing to pay high prices to get many deals done quickly. If enough acquisitions are completed quickly enough, the major stockholders can often sell out before their stock crashes. Once consolidators stop growing quickly, their share price usually drops like a rock and their stock is devalued, the expenses catch up, and they go bankrupt. As noted in *Fair Value*, Summer 2000, "A number of publicly traded consolidators have actually gone from the concept stage at formation, to implementation, to IPO, and ultimately to bankruptcy in three years or less." *If selling your agency to a consolidator, do not sell for stock that cannot be cashed quickly!*

Obviously, getting big at the price of bankruptcy does not make sense (unless the real goal is to get big enough for a major shareholder to sell out before the crash). Getting big does not make sense for other reasons as well. For example, the *Wall Street Journal* (7-13-00) reported on a 40-year study of 20 industries that found all giant global corporations (except those in the semiconductor industry) had a steady decrease in market share concentration. Smaller, more nimble firms were always able to find ways to gain market share. Another study showed that almost all number one market share firms had lower profit margins. So why work so hard just to get big? Are the bragging rights worth it?

The Economist wrote in its January 27, 2001 issue, "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." Being all things to all people is quite a burden and if it is mandatory for success, which it is based on the premiums so many banks are paying for agencies, investors may find many great opportunities to sell short.

Grand schemes of cross-selling is another "bigger is better" trap. Many financial firms are buying other financial firms today because they believe consumers want to buy all their financial services and products from one vendor. Wall Street recently thought the same thing about voice/cable/data services. They were wrong then too. Today, AT&T is making plans to split up because they found consumers did not necessarily want one-stop shopping for these services or perhaps AT&T just could not provide good enough one-stop shopping service. The problem with cross-selling is the provider must be the best at all services they offer. Being the best in one area is tough enough. Being the best in all categories is almost impossible.

In fact, a *Wall Street Journal* article from the summer of 2000 titled, "Bank-Run Mutual Funds Perform Poorly," stated, "The typical bank-run U.S. stock mutual fund, however, is a poor performer, badly lagging behind the mutual-fund industry average last year and off so far this year, as well." Reuters reported on August 24, 2000 that, "Banks are losing droves of customers who are fed up with bad service…More than 60% of consumers polled…said they have canceled bank accounts, frustrated by poor service." This compares to 36%, in the same poll, that had changed insurance providers.

Banks and insurers in many European countries have been trying unsuccessfully for years to sell one-stop shopping and have continually not lived up to their own expectations. So far, the U.S. has not proved to be different.

Banks make a good example because they have bought and are buying so many agencies. If they cannot satisfy customers with their banking services and provide better results with mutual funds, I do not believe most can succeed selling insurance. After all, banks selling insurance is a much further stretch than banks selling banking services. And so far, banks do not appear to be terribly successful at selling insurance. A study by Marsh-Berry appearing in *Best Week* February 26, 2001 showed that bank owned agencies are only growing by .3% versus the industry average of 5.2%. Also, their EBITDA (earnings before interest, taxes, depreciation, and amortization) is only 67% of industry average. In other words, bank owned insurance agencies are writing less business, less profitably.

Consolidators and bank owned agencies are providing opportunities for other insurance agencies.

Good producers will leave banks and consolidators when their salaries are cut. Customers will leave when producers leave. Customers will leave when service crashes. Customers will leave when expectations are not met. Customers will leave when nimbler, smaller, and more personal competitors offer superior service. For example, *The Economist* reported that every time Bank of America would make an acquisition, one particular competitor would open a nearby branch to capture all the newly acquired firm's dissatisfied customers!

An article in the April 16, 2001 *Albuquerque Journal* cited another great example. Wells Fargo purchased First Security, then sold 22 branches to Bank of the West. Meanwhile, a competitor, First State Bank, opened 40% more new accounts in one month alone primarily due to Wells Fargo's and Bank of the West's acquisitions as customers left due to poor service.

Getting big using costly methods (acquisitions of other business, underpricing business, big and difficult cross-selling programs) usually does not work. Once engaged in these methods, these entities must grow significantly to justify the costly and high risk strategy being pursued. Getting big through internal growth, while slower and less glamorous, does work and has continually proven to be the most profitable method for growing a company. However, while growth is important (especially for small agencies), no extreme pressure or need exists for privately held, non-consolidator agencies, non-bank owned agencies to grow extremely big quickly. With rates increasing, most agencies should easily achieve 8%-10% annual growth. Smart, profitable, internal growth will inevitably provide bigger profits and higher agency values.

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