



Mike Berris

New Survey Encourages BENCHMARKING

STUDY HIGHLIGHTS FINANCIAL PERFORMANCE OF BROKERAGES

By Barbara Aarsteinsen

After 20 years of dealing with the insurance brokerage industry, Mike Berris has a pretty good idea what tends to either improve or drag down performance. He has an intuitive sense of trends and developments and lots of anecdotal evidence to support his theories. But he wanted to back up his suppositions with hard facts and figures.

So five years ago, Berris, co-founder of Vancouver-based Berris Mangan Chartered Accountants and leader of the firm's insurance consulting group, decided to poll brokerages of various sizes and composition to get a handle on profitability in the sector and what enhances or diminishes it. He had been

maintaining a database of brokerage clients' financial results and in 2003, he compiled the information in a 10-page summary that was provided to existing customers only.

In 2005, Berris Mangan, a full-service accounting firm, expanded the report to include non-client brokerages, seeking to highlight some of the commonalities shared by "class A" brokers that earned greater-than-average profits. This was a step forward, but Berris felt that the survey, and others like it, was still missing something important – that is, it needed more insights and not just observations.

So, in 2007, he was determined to publish an insurance brokerage profitability study that "could add real value

to the industry." His goal, he says, was to generate academic-style research, not simply a promotional tool. He says he had become "obsessed" by the figures and trends and was pushed to keep digging deeper and deeper.

Methodology

Last April, a two-person full-time research team was formed and 500 brokerages across the country were asked to participate. In the end, 206 brokerages from coast to coast were involved. As well, 130 separate employee questionnaires were contributed.

Berris says he feels pretty good about the level of response because brokers are very protective of their business information and many do not

Although there is no one reason why small brokerages are less profitable, it generally comes down to the basic cost of operating a brokerage office, especially one that has extended or weekend hours. Small brokerages are often unwilling or unable to move to better retail locations. Also, it takes a tremendous amount of investment of time and money to develop the systems that will allow for growth. These are the brokers that are most likely to consider selling, maybe even earlier than they should, because of the challenges they face in the marketplace.

even regularly measure their own key performance indicators. He stresses that all data is kept strictly private. Indeed, once responses were received and plugged into the financial model, company names were deleted and participants were identified only by code.

For the next study he has planned, slated for 2009, he hopes to recruit more participants, plus pose further questions and explore additional topics. "If 206 participants provide the industry with useful information, think what a sample of 500 would yield," he says.

The data-gathering phase was completed in October 2007, and the next two months were devoted to developing a comprehensive statistical model that Berris insisted on to "give a high

degree of confidence that our results truly represented the financial results of brokerages in Canada."

The accountant notes that some professionals are hesitant about benchmarking because it has judgmental overtones – the implication of separating the winners from the losers, and nobody wants to think that they're in the loser category.

He says the objective is to identify the things that top brokers are doing that lead to improved profitability and to view those findings as a list of options. The idea is for brokers to select the measures and activities that they think will work in their particular context and not to take the findings as a template that must be adopted.

"There are many different ways to put a puzzle together," Berris says. "I like to think I am providing a series of boxes representing the various things that class A brokers are doing. Then you colour in some or all of the boxes for your own brokerage. You don't necessarily have to do the exact same thing. The goal is to start moving in the right direction, not simply take the same path that somebody else has."

Berris also emphasizes that changes

Benchmarking Tips

Berris Mangan urges brokers developing a benchmarking system to remember important considerations such as:

- Ensure that your accounting and policy management systems are capable of tracking financial data that is meaningful to your success.
- Don't just benchmark your performance against brokers your own size. Compare your firm against various-sized organizations and profitability segments.
- Compare your results to brokerages that have a similar sales mix. These firms tend to have similar staff organization and cost structures.
- Regional differences tend not to be a significant factor when analyzing data on a percentage basis.
- Specific factors that affect your operations may influence the comparison with other brokers that appear to be a good comparison.
- Understand how rising and falling premium levels will affect your operating profit.
- Prepare financial projection models and include them as part of your monthly financial reporting.

Average Results Comparison by Profitability Level

Total Sample Size: 164	75		89	
	Profits <18.5% Average of Sample		Profits >18.5% Average of Sample	
	\$	%	\$	%
Income				
Public Auto	152,564	31.5%	202,552	29.6%
Private Auto	20,841	4.3%	21,743	3.2%
Travel	1,762	0.4%	1,897	0.3%
Personal Lines	144,288	29.8%	212,734	31.1%
Commercial Lines	124,813	25.8%	166,161	24.3%
Contingent Profit	27,892	5.8%	45,369	6.6%
Other	12,332	2.5%	34,190	5.0%
Total Income	\$484,491	100.0%	\$684,647	100.0%
Total Personnel	313,639	64.7%	317,585	46.4%
Total Administration	67,265	13.9%	78,984	11.5%
Total Premise	47,062	9.7%	39,169	5.7%
Total Data Processing	10,108	2.1%	9,017	1.3%
Total Marketing	16,749	3.5%	20,893	3.1%
Total Expenses	454,822	93.9%	465,649	68.0%
Net Operating Income	\$29,669	6.1%	\$218,998	32.0%

Average Results Comparison by Branch Size

Total Sample Size	94		51		19	
	\$0-500k		\$500k-1M		>\$1M	
	Average of Sample		Average of Sample		Average of Sample	
	\$	%	\$	%	\$	%
Income						
Public Auto	103,586	36.5%	254,203	36.4%	356,210	19.3%
Private Auto	8,362	2.9%	31,732	4.5%	57,570	3.1%
Travel	1,066	0.4%	2,912	0.4%	2,749	0.1%
Personal Lines	102,382	36.0%	208,267	29.9%	500,493	27.2%
Commercial Lines	46,551	16.4%	130,758	18.7%	689,729	37.4%
Contingent Profit	13,912	4.9%	40,355	5.8%	145,468	7.9%
Other	8,196	2.9%	29,203	4.2%	89,900	4.9%
Total Income	\$284,056	100.0%	\$697,430	100.0%	\$1,842,120	100.0%
Total Personnel	157,241	55.4%	339,861	48.7%	986,095	53.5%
Total Administration	42,427	14.9%	94,065	13.5%	238,290	12.9%
Total Premise	31,114	11.0%	51,999	7.5%	112,586	6.1%
Total IT	8,067	2.8%	13,772	2.0%	26,077	1.4%
Total Marketing	7,597	2.7%	18,051	2.6%	62,164	3.4%
Total Expenses	\$246,446	86.8%	\$517,747	74.2%	\$1,425,212	77.4%
Net Operating Income	\$37,609.91	13.2%	\$179,683	25.8%	\$416,908	22.6%

cannot be made overnight. It takes years, not weeks or months, to bring about a corporate culture shift, he says. "I have a high degree of confidence that if you read this study and start changing your practices, you will become more profitable in time. But that is a two- or three-year process.

"You can't implement these things instantly," he cautions. "As a broker owner or manager you have influence but not that much power. You can influence CSRs to answer the phone a certain way or branch managers to conduct their operations in a certain way. But it's hard to demand or command."

Overall results

According to Berris, the statistical findings were evaluated via identification of trends, correlation analysis and tracking the impact of operational and sales mix changes since the 2005 study. At the same time, he also wrote several white papers on issues that clients seemed concerned about, from mergers and acquisitions to the changing roles of brokers in the industry distribution system.

Some of the results were fairly obvious

findings, such as commercial lines drive profitability for larger brokers, Berris points out. But other subtler aspects of brokerage systems that seem to affect profitability were also unearthed. Some of these issues, he notes, have been debated in the industry for years, like the effect of IT expenditure, advertising, training, sharing information with employees, transactional filing and direct bill processing.

Three particular findings stand out, Berris elaborates. He says he was surprised by a shift away from commission producers, by the ground being lost by small brokers, and by how money spent on marketing and advertising tends to have a more positive impact than technology investments. He was also taken unawares by the seeming correlation between broker profitability and employee satisfaction.

"Employees unhappy with their work environment generally work at less profitable brokerages," Berris outlines. "Then, of course, it becomes one of those chicken-and-the-egg questions. Are they unhappy because there are not enough resources to go around and they're sub-

Moving Up the Ladder

Berris Mangan says that for brokerages to be able to transform a "good business" into an "elite organization," a number of underlying conditions are necessary.

- The organization must first have confidence in its leaders before change can take place.
- Management and employees are able to face the truth about areas that need to be improved.
- The organization's management is willing to participate in the development of a written plan on what they want their brokerage to look like, and have committed to the steps they will take to get there.
- Managers are willing to take responsibility for setbacks and are constantly changing their tactics to respond to changing conditions.
- The organization is willing to invest the time and money to improve operations. It generally takes at least three years to truly change an organization's culture and operating environment.

Brokers can improve customer service and generate higher profits, but the process takes discipline, hard work and a significant investment of time and money. The problem is that the cost of these changes can be immediately measured in time and money, but the expected return is often viewed as too uncertain or far off to justify the investment. This naturally creates a bias for maintaining the status quo.

jected to more financial pressures, or is the brokerage underperforming because the employees are discontent.”

Notable findings

The study's findings are separated into five sections, looking specifically at sales analysis, expense analysis, 2005/2007 comparisons, employee survey and other factors affecting profit.

Some of the major highlights include:

- The most profitable brokerages' income is between \$800,000 and \$1 million.
- Only 11 per cent of Canadian brokerage offices have sales greater than \$1 million.
- The average industry profitability equals 25.3 per cent of income.



- Average contingent commission income is 5.7 per cent of total income.
- The bottom 25 per cent of the industry earns less than 8.5-per-cent profit while the top 25 per cent earn more than 30 per cent in profit.
- The top half of all brokers earns 92 per cent of all the profit. This suggests that the reward for good business practices is significant.

Profitability is defined as earnings before interest, taxes, depreciation and amortization. Berris Mangan

says this effectively attempts to put each brokerage on an even analytical footing regardless of how the business is financed, tax rates or amortization policies.

Profitability is equated to percentages. For example, the average profitability of the selected sample size is 18.5 per cent; that is, for every \$100 of commission and other income there is a resulting profit of \$18.50.

Broader conclusions


Based on all the various findings, Berris Mangan draws some broader-based conclusions:

- Considerable merger and acquisition activity will continue, and prices for well-managed brokerages will remain strong for the foreseeable future. Most brokerages will be offered for sale using a three times multiple of total commissions, but the business will ultimately sell at multiples that translate to six to eight times post-acquisition cash flow.
- At the same time, deals do not always go forward. In some cases, a broker, anxious to expand will enter into the negotiation process and sign a letter of intent where the seller is expecting to receive a price equal to three to four times total commissions. The potential purchaser realizes the acquisition is not economically viable and will then try to either adjust the offering price or back out of the deal entirely.

In most cases, when a deal fails to close, it is because the cash flow cannot justify the price and the vendor refuses to consider a lower commission multiple. Regardless of the method used, the cash flow generated must ultimately support the purchase price paid.

- In the past, contingent commis-

sions and premium financing income were generally excluded from the calculation of purchase price. This no longer appears to be an industry standard as vendors expect a multiple on all premium-related income.

- Although brokers should continue to expect a high price for their business, it is strongly recommended that they prepare their business for sales by increasing profitability and targeting potential purchasers that are able to pay the highest price.
- There has been a shift from valuing brokerages by a commission multiple to EBITDA multiples. Nevertheless, most brokers still view their potential value as a multiple of commission value. Purchasers are now more interested in evaluating a brokerage's potential based on the post-acquisition cash flow or EBITDA. In recent years, the multiple varies between six and eight times EBITDA.
- Larger organizations will also analyze a potential acquisition using their own evaluation criteria, which may include return on investment, payback, net present value and internal rate of return analysis.
- There will be continued pressure on independent brokers through consolidation in the industry and competition from direct sellers. Still, well-managed brokerages that understand their place in the distribution chain and have the skill to exploit sales opportunities should be able to prevent significant loss of business and, in many cases, thrive. This state of affairs will prevail in the short run, but prices will scale back as industry conditions change and purchasers put more emphasis on the cash flow of the acquired business. 

SPECIFIC FINDINGS

Sales Analysis

A detailed analysis was carried out of how brokerages' sales mix affects their size and profitability. Berris Mangan partner Mike Berris says considerable attention was focused on how sales mix influences growth and expense management. Some of the conclusions included:

- Sales mix was very similar in smaller brokerages.
- Location and local competition dramatically affected sales of automobile and personal lines sales.
- Commercial lines sales drive growth and profitability in larger brokerages.
- Smaller brokers have more success by improving systems and concentrating on personal lines marketing.

Expense Analysis

In this section, expense management was analyzed, with sales mix compared with expenses and profitability. Expenses were also reviewed by class and their influence on profitability measured. The sample was assessed as a whole by brokerage size and, most importantly, by profitability. Going one step further, expense levels in 2007 were compared with those in 2005, and the effect on profitability estimated. During this review it was discovered that:

- Investment in information technology tends to have a negative impact on profitability as opposed to marketing and advertising expenditures, which have a positive effect. IT systems only have value if they support the customer service model.
- More profitable brokerages rely less on commissioned producers but replace this expenditure with alternative compensation arrangements and training.
- Larger brokers earn the best return from investment in marketing and information technology expenses.
- The more profitable brokerages have increased overall expenses by 7.6 per cent since 2005 while the less profitable increased expenses by only 1.6 per cent.

Profitability Analysis

In this section, sales mix was compared with expenses and other factors that help determine profit. As well, the profitability of brokerages from the new study was set against that of the 2005 participants. The findings included:

- Smaller brokerages are less profitable than larger brokerages as they are only earning 17.1 per cent of total profit on 27.5 per cent of the commission income. It is suggested that this relates to the basic fixed costs that must be borne by a brokerage regardless of sales volume.
- Medium brokerages tend to be very effective in obtaining more than their share of the auto business. It is assumed that these brokerages were able to increase volume due to superior locations.
- Smaller brokerages do not have the resources necessary to develop and retain commercial accounts. This accounts for their small share of the commercial lines business. Berris Mangan says it is not surprising that large brokerages (with more than \$1 million in commission) have captured 54 per cent of the commercial market, whereas they only control 36 per cent of the total market.
- Larger brokerages have clear competitive advantages in commercial lines. Concentration in commercial lines is also reflected in larger contingent commissions, probably because of larger premium volumes and better loss ratios.

- Small brokerage sales growth is not keeping pace with cost increases.
- Small brokerage (less than \$500,000) profitability has decreased by 0.9 per cent since 2005.
- Contingent profit levels are declining for smaller brokerages, as they are unable to deliver adequate volume or underwriting results to their insurance markets.
- The shift to commercial lines has a significant positive impact on profitability.
- The profit of smaller brokerages is driven by personal lines growth and systems such as automobile marketing, direct billing and transactional filing.
- Profitable brokerages rely more on system and less on branch managers. This is reflected in lower pay levels for managers.

Employee Systems

In this section, employee systems and wage levels were analyzed and compared with branch profitability. Employee systems that positively and negatively affect brokerage profitability were highlighted.

- Organizations that have regular employee reviews and set SMART (specific, measurable, attainable, relevant and time-based) goals are the most profitable.
- Commissioned producers have a slight negative effect on profitability but can drive up brokerage volume and potential sales value. Only 37.2 per cent of the participants have commissioned producers but these same brokerages tend to pay producers and customer service

Big or Small?

Consider a medium-sized brokerage with sales of \$900,000. It is well balanced financially, Berris Mangan concludes, and can invest in systems and hire high-quality talent. However, it lacks the volume that would allow it to get greater underwriting flexibility and pricing from its markets. Consequently, it needs to find ways to partner with insurers or perhaps other brokers.

A larger brokerage, on the other hand, has financial strength and can deliver larger volume to its markets, but they tend to lack agility. The result is a less efficient organizational structure and management.

"We are not saying it is better to be small or to be big, but, rather, it is important to know what you are and what areas you need to focus on to improve results," the firm suggests.

SPECIFIC FINDINGS

- representatives higher salaries overall.
- Many brokers still manually paper-file client information.
 - Profitable brokerages set targets and share production results with their employees. Because customer relationships are the most important asset that a broker has, employees understand what the customer service standards are for each class of customer need.
 - Employee remuneration is only slightly higher in the most profitable brokerages.
 - Staff turnover issues have the largest effect on organizational effectiveness, followed closely by training and communication.
 - Many brokerages do not invest enough in training. For every \$100 spent operating a brokerage, only \$1 typically goes to training. This contributes to employee frustration and turnover.
 - Profitable brokerage employees complained about a lack of sales material while poorer-performing brokerage employees beefed about workload.
 - Only 14 per cent of brokers require their employees to submit reports on key performance indicators (KPI) and record them with a performance tracking system. This is an extremely important function in creating a culture of improvement. The organization must be careful that the KPI monitoring is done in a positive manner and is customer-focused.
 - Many multi-branch brokerages without a strong central control system begin to

become less effective and less profitable. This is probably attributable to branch managers who basically decide to go their own way as far as operating procedures are concerned.

Profit Improvement Strategies


This section outlines and summarizes the common characteristics of profitable brokerages. Berris Mangan also looked at sales systems and customer types, identifying the main reasons why clients switch brokerages and providing strategies that may stop defections and target markets more effectively.

- Most commercial lines customers will switch brokerages on price unless specific service standards are introduced. Keep in mind that most switchers have difficulty explaining the difference in coverage levels. Other reasons, in order of importance, include poor service, poor claims experience, better coverage and change in agent.
- Personal lines customers will switch for price but many of these same customers can be retained with a moderate amount of customer contact. Other reasons for switching include lack of attention, poor explanation of policy, and limited carriers available.
- Customers should be grouped by needs, expectations and profitability, in that order. Marketing strategy is more successful if it's focused on market segments rather than on revenue potential. There are many situations where

low revenue and high service requirement customers eventually become very profitable.

- New systems should never be introduced without clearly demonstrating their return.
- Employees must be given clear expectations and goals and held accountable to them. About 65 per cent of respondents regularly undertake employee wage and performance reviews.
- The ability to market specific expertise is a classic example of creating competitive advantage. Only 21 per cent of the participants have been able to do so. Keep in mind that rural brokers have less potential to specialize.
- Only 48.8 per cent of respondents contacted or marketed to existing automobile customers. Auto retention rates can be improved by up to 25 per cent with simple customer contact such as renewal letters and phone calls.

"We do not think or even advise that you change your brokerage immediately to match the characteristics of those brokerages that are more profitable than yours," Berris Mangan cautions. "They may be in better retail markets, their staff may insist on a different culture or their managers may work 60 hours a week.

"Instead, we believe a practical manager will study the business traits we have highlighted in this study and apply them to their organization in a manner that is appropriate given their particular circumstances." 



Berris Mangan Chartered Accountants is a full-service accounting firm based in Vancouver. It has a roster of 60 professional accountants plus support staff. The firm represents more than 65 p&c brokerages throughout Western Canada as accountants and business advisors.

Mike Berris is co-founder of Berris Mangan and leads the firm's insurance consulting group, which focuses on helping clients identify opportunities, and develop and implement strategies for increasing profits and long-term agency values.

Berris has spent 20 years representing insurance companies and p&c brokers in acquisitions, mergers and profitability planning. He has also taught courses on brokerage acquisition and succession strategy and developed a profitability management training program. He is a graduate of the University of British Columbia's Sauder School of Business. He has a chartered accountant designation and has taken advanced training in professional service firm management at the Harvard University Executive Training Faculty in Cambridge, Mass.

For more information on Berris Mangan and its Insurance Broker Profitability Study, contact the firm at (604) 682-8492. Check out its Web site at www.berrismangan.com.