



A Big Catch



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Results of a broker profitability survey suggest mergers and acquisitions might be the best way to achieve growth these days.

In our 20 years working with insurance brokerages throughout Canada, we have often been asked the question: “How do I improve my operating results?”

The question usually arises after seeing a competitor buy a new boat, or upon hearing the news that a daughter has been accepted to Columbia University in New York without a scholarship. One simple answer is to sell more insurance. We all know that this is easier said than done.

Thus, brokers might benefit from a report providing them with industry benchmarks from which to compare their performance. We wanted to generate academic-style research, not simply create a promotional tool. Our objective was to identify the strategies used by top brokers that resulted in improved profitability.

METHODOLOGY

After more than a year of work, the Berris Mangan Insurance Consulting team recently completed the fourth edition of the 2010 Property & Casualty Insurance Brokerage Industry Report.

The report surveyed brokerages throughout the country. Participants provided their internal operating results as well as completed a written survey. In total, 285 brokerages provided details of their income and expenses. Total income ranged from \$25,000 to more than \$9 million on an individual branch basis. Operating profit margins also varied greatly from a 500% loss to a profit margin of 76%.

OVERALL RESULTS

As a starting point, let’s look at the average operating results from our fourth edition (Please see Table 1 on Page 28). The average brokerage office earned an operating profit before income taxes and amortization of 30.6%. We felt it was important to attempt to understand how industry profitability affects the behavior of industry participants. What trends are emerging based on how profit is being allocated amongst industry

participants? One might say outcomes affect behavior, which in turn affects future outcomes. This is the basis for all industry cycles. Here are some of our observations:

- higher prices paid for brokerages are requiring better management discipline in order to get an adequate return on one's investment;
- books of business are being consolidated, creating more market clout. This increases revenue and underwriting capacity. Such a dynamic gives larger brokers a competitive advantage; and
- the insurance industry is a classic mature industry: market growth is only slightly higher than the rate of inflation. Market participants can only achieve meaningful growth through acquisitions and price competition. We have seen this in action, with a five-year soft market and an unprecedented number of acquisitions.



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TRENDS IN THE INDUSTRY

We all understand the distribution of property and casualty insurance is consolidating through mergers and acquisitions. As this happens, other industry players will react to these changes. We are seeing the following trends emerge:

- direct writers are actively testing new methods such as affinity programs and narrowly directed marketing programs;
- agency arrangements such as those offered by State Farm and Cooperators will grow. They are offering young entrepreneurial brokers the ability to participate in the industry without significant capital;
- larger brokerages are generating income from life insurance and financial products.
- insurance companies are continuing to fund acquisitions and shareholder buy-outs, but with retention and growth

conditions attached;

- large U.S. brokerages are looking to move into Canada in search of greener pastures;
- highly skilled underwriters and brokerage employees will enter the market by starting niche brokerages; and
- managing general agencies are thriving: they are filling capacity and underwriting needs the domestic market cannot or will not service.

PROFITABILITY ANALYSIS

Our research divided and analyzed the sample group into various categories, including the size of the brokerage, the province in which it operates and profitability. We were particularly interested in analyzing characteristics influencing profitability. As a starting point, we looked at brokerages earning more or less than the sample average. (Please see Table 2 on Page 30.)

On first glance, 126 (44%) of the respondents had results greater than the average profitability of 30.6%. More importantly, these brokerages earned profits of 41.1%. This is a 26.6% better return on sales than the 159 brokerages performing below average.

These differences appear dramatic, but

it is important to separate management issues from market or structural issues. Brokerages generally have a number of fixed and semi-variable expenses that are incurred regardless of commission volume. For example, a brokerage open 9 a.m. to 6 p.m., Monday to Saturday probably needs 4.5 full-time equivalent employees. In other words, it comes down to volume. In most Canadian towns, a brokerage office will have difficulty making a profit with commission income under \$350,000. We see how this drives consolidation: larger, multi-branch brokers can often bring efficiencies to bear, thus reducing costs or increasing income.

In analyzing characteristics affecting profitability, we need to understand what enhances or diminishes profitability. Successful strategies exist in every market. Some of our major observations include:

- expense management has an obvious effect on profitability, but a significant difference to profitability did not appear between brokerages of similar size.
- automobile and personal lines commission mix is closely correlated; it is

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dependent on certain local economic statistics. Commercial sales tend to drive profits for brokerages with commission income of more than \$800,000.

- brokerages at the top end of the profitability range tend to look the same, in that they have centralized renewal systems, established programs and a dedicated management group. On average, brokers with more than 10 offices earned more than 40% of their operating income through sales; and
- an office with sales in the \$1-million range tended to be the most effective in

terms of labour costs. This volume allows for a better segregation of duties and allocation of work.

Both the above-average and below-average performers had an average number of full-time equivalent employees of slightly fewer than nine people. But the below-average performers produced \$85,004 of revenue per employee, compared to \$134,586 of revenue per employee for the above-average performers. This tells us that productivity is the largest contributor to profit. Our report has more specifics on different aspects of employee productivity. For example:

- the top 25% of brokers track profitability by department and measure



employee productivity;

- advertising and promotion does not appear to correlate directly with overall profitability and sales growth. High-profit brokers concentrate marketing on large-client entertainment;
- 86% of above-average brokerages hold employees responsible and tie wage increase into performance goals. Only 18% of below-average brokerages do this;
- brokerage offices with more than \$1 million in sales earn 67% of all available profits;
- small brokerage sales are not keeping pace with cost increases;
- 89% of all above-average brokerages employ commissioned producers, paying an average of 45% on new business and 35% on renewal;
- wages for above-average brokerages are \$6,000 higher than they are for the below-average group; and
- the most profitable brokerages don't share overall results with employees. Instead, they focus on department and individual production and processing goals.

Table 1

Average Operating Results		
Total Sample Size:	285	
	2009 Sample	
	\$	%
Income		
Auto	\$336,534	35.9%
Personal Lines	\$312,848	33.4%
Commercial Lines	\$207,555	22.1%
Contingent Profit	\$34,099	3.6%
Other	\$46,283	4.9%
Total Income	\$937,319	100.0%
Total Personnel	\$454,109	48.4%
Total Premise	\$64,883	6.9%
Total Data Processing	\$11,708	1.2%
Total Marketing	\$28,055	3.0%
Total Administration	\$91,808	9.8%
Total Expenses	\$650,563	69.4%
Operating Income	\$286,756	30.6%

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THE FUTURE

It is important to understand what compels brokerages to make changes to improve their business model. The answer is simple. Necessity drives change. That is, people or organizations will not change unless they are forced to. Some factors influencing change in the delivery of insurance include (but are not limited to) the following:

- many mid-tier brokerage owners will be retiring in the next five years. In order to finance the transfer, new owners

will have to introduce better systems; and

- brokerages will need more flexible markets. This will increase the demand for managing general agent markets until brokers are able to develop underwriting facilities beyond the traditional Lloyd's brokerage model. Going beyond the traditional brokerage model will require more volume and continue to encourage consolidation.

The quality and engagement of personnel is the single most important



driver of profitability. Larger brokerages and insurance companies will find new ways to develop employee skills through internal and external training. Organizations such as IC3 and Sikkens International have developed excellent training and staff development programs.

Never underestimate the ability to survive and thrive in any market conditions. There are changes coming in the industry, but there won't be anything happening that the brokerage industry cannot handle. ≡

Table 2

Average Results Comparison by Profitability Level				
Sample Size: 285	159		126	
	Profits <30.6%		Profits >30.6%	
	Average of Sample		Average of Sample	
	\$	%	\$	%
Income				
Auto	\$299,640	40.1%	\$383,090	32.5%
Personal Lines	\$251,980	33.7%	\$389,658	33.1%
Commercial Lines	\$130,900	17.5%	\$304,287	25.8%
Contingent Profit	\$23,549	3.2%	\$47,413	4.0%
Other	\$40,988	5.5%	\$52,965	4.5%
Total Income	\$747,057	100%	\$1,177,413	100%
Total Personnel	\$431,912	57.8%	\$482,120	40.9%
Total Premise	\$61,902	8.3%	\$68,646	5.8%
Total Data Processing	\$12,352	1.7%	\$10,895	0.9%
Total Marketing	\$29,748	4.0%	\$25,920	2.2%
Total Administration	\$80,630	10.8%	\$105,914	9.0%
Total Expenses	\$616,544	82.5%	\$693,495	58.9%
Operating Income	\$130,513	17.5%	\$483,918	41.1%