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2009 Financial Management Review

This edition of The MarshBerry Letter is dedicated to a review of peer statistics to assist the reader in important aspects of agency financial management. An annual review of your income statement and balance sheet is imperative to identify opportunities to enhance growth and manage current and long-term financial obligations. We will outline the typical financial operations of agencies within specific peer groups and a well-managed agency, in addition to providing explanations and guidance for your own analysis.

To assist in the analysis of your agency's performance, included with this month's newsletter are the Average Agency Income & Expense Composite Ratios and Key Balance Sheet Ratios based on four different agency size groups. The size levels are expressed in revenue (not premium), so be sure you select the correct column for comparison purposes. The four composite groups in Table 1 (page 3) and Table 2 (page 4) present the average income and expense ratios and balance sheet ratios for agencies throughout the United States. These ratios are derived from the MarshBerry database and the 2008-2009 results of hundreds of firms that participated in this year's Market & Financial Survey. The fifth column of Table 1 contains the Suggested Pro Forma ratios for a well-managed agency and illustrates how an agency would look through the eyes of a third party buyer who would be trying to maximize growth and profitability rather than private ownership return. The fifth column of Table 2 contains recommended balance sheet ratios for a well-managed agency. It is important to note that these are suggested ratios and every agency has different circumstance that may alter its ability to manage to the indicated expense levels.

Income and Expense Analysis

To begin your financial analysis, we recommend that you put together a three to five year historical income and expense statement including your preliminary numbers for the current year using the same categories as shown in *Table 1*. Most of the categories correspond to standard financial reports. However, to avoid any misinterpretation, listed below are explanations for each category:

- *P-C Commissions – Property & casualty agency bill and direct bill commissions*
- *Life & Group Commissions – Commissions from health & accident, life, group policies, variable annuities, pension and profit sharing plans, life & health overrides and financial services*
- *Fees - Earnings from consulting, risk management, countersignature, inspection, engineering and finance charges*
- *Contingent Income – Commissions received as contingent payments, including bonus commissions and profit sharing from companies (property & casualty contingents only)*
- *Investments – Interest income, dividends, annuity receipts, etc.*
- *Miscellaneous Income - All other items of income not classified properly in any of the other income categories, e.g. gain/loss on the sale of agency assets*
- *Outside Commission Expense - Commissions paid to other agencies or people outside of the agency as well as any countersignature expense*
- *Executive Payroll - Payroll and bonuses paid to individuals acting in the capacity of high level management positions within the agency -- this category typically includes the CEO, President and COO*
- *Production Payroll – Payroll, bonuses and commissions to owners and producers whose primary responsibility is selling to new and existing customers; sales managers and sales coordinators are also included if they are directly soliciting business and/or appointments from prospective customers -- note that any individual who performs both executive and sales functions should be allocated to both categories based on the amount of time spent on each function*
- *Service & Support Payroll – Payroll and bonuses to staff other than executives and producers directly engaged in the servicing of customers and those in a support role performing managerial or administrative duties, including the CFO*
- *Retirement Benefits – Company paid retirement plan contributions, 401-K plans and administration fees*
- *Non-Retirement Benefits – Payroll taxes, group health & accident, group life insurance, disability, employee premium discounts, education and training costs*
- *Travel & Entertainment - Company paid expenses relating to travel (other than auto) including airfare, trains, hotels, meals, social clubs, etc.*
- *Automobile - Mileage, auto leases, gas, oil & maintenance costs, parking, auto insurance, rental car expense and auto license fees*
- *Advertising & Promotion - Advertising, customer relations, meetings, conference costs, gifts, promotional items and contest awards*
- *Facilities - Rent, utilities, property maintenance, and real estate taxes (property taxes)*
- *Telephone – Local and long-distance charges, costs of cell phones and cellular service, telephone and telecommunication expenses associated with automation of the agency (e.g. dedicated line costs, interfacing costs such as upload/download, Internet or on-line service costs) and maintenance costs on purchased phone systems are included here -- leased phone systems are included in equipment rental*
- *Postage – Postage as well as air freight, special delivery charges, telegrams, etc.*
- *Office Supplies and Printing - All material used in the office, e.g., letterhead, pens, pencils, special printing charges, business cards, etc.*

- *Dues, Subscriptions and Contributions - Magazines, reader services, special report costs (e.g., RIA and Best's), purchased books, journals and newspapers; all dues to associations, business groups, clubs (non-entertainment) and organizations as well as any charitable contributions*
- *Licenses and Miscellaneous Taxes - All local taxes, personal property taxes, franchise tax on assets or sales and all licensing costs are included here -- payroll taxes, real estate taxes and state & federal income taxes are not included*
- *Insurance (P/C and E/O) - The agency's own property and casualty insurance costs, including its E&O insurance -- employee benefits insurance or the cost of officers' life insurance are not included*
- *Professional Fees - Legal, accounting and consulting fees*
- *Equipment Rental and Maintenance – Cost of small office equipment purchases, all machine leases and service contracts (e.g., computer, copiers, etc.), all computer software purchases which are expensed, automation expenses related to equipment rental & maintenance (e.g. automation service agreements, automation lease payments)*
- *Bad Debts - Include all claims losses and any amounts advanced which are not collectible -- any recovery of a previously deducted item is offset to this account*
- *Outside Services – Any services not reported in professional fees (e.g., computer service, MVR's rating services, bookkeeping, secretarial, cleaning, janitorial, collections and temporary services)*
- *Miscellaneous Operating Expenses – Any operating expense not covered by any other account (e.g. bank charges, moving fees, outside director fees, etc.)*
- *Depreciation of Tangible Assets – Periodic charges to reflect diminishing useful life of tangible assets (e.g., equipment, building, autos)*
- *Amortization of Intangible Assets – Periodic charges to reflect diminishing useful life of intangible assets (e.g., non-compete covenants, insurance renewals, restrictive covenants, incorporation costs)*
- *Officer's Life Insurance – Company paid insurance with the company as a beneficiary (e.g., retired life reserves and key man)*
- *Interest Expense – Finance and interest charges for the use of money (e.g., mortgages, notes, installment loans)*
- *Miscellaneous Administrative Expense – Any other administrative expense not listed above (e.g., deferred compensation payments)*

After preparing your own statements in this format, you will be able to analyze your agency's performance in terms of Net Revenues, Total Expenses, Pre-Tax Profit, and EBITDA. EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) represents the true earnings of an agency and is one of the primary factors in determining agency value. Comparisons can be made based on an agency's peer group, the agency's historical performance, and versus the suggested pro forma ratios of a well-managed agency.

Using the appropriate size peer group in Table 1, compare your income and expenses with the averages. The peer group averages presented should be used as an initial guideline to determine where your agency varies, but should not necessarily be taken as absolute benchmarks for suggested performance. All agencies are unique and there may be reasons why your results do not track exactly with the averages. For example, a small agency may have higher facilities costs due to excess space (providing room for growth), and a large agency may also have high facilities expenses if it has multiple locations. Identify the reason why your numbers may be different and determine if the variance is acceptable or desirable.

Not only should you compare your numbers to the "average", but also look at how the income and expenses have trended over a three to five year period. A historical analysis will help to identify trends in expense increases, especially in this tough economic environment, where revenue growth can be difficult. Without revenue growth, it is important to cut expenses to a corresponding level where the agency can be profitable, but not stifle growth opportunities. Begin your analysis by identifying those areas that have seen a dramatic increase and determine the cause for that increase. For example, is an increase in telephone expense due to the purchase and expensing of new phone equipment or is it time to re-evaluate your current phone service provider and obtain a price quote from competitors? Do your producers have individual cell phone accounts or is everyone under one plan? In the final analysis, you will want to identify areas where improvement is possible and develop a strategy for making those improvements.

The results in *Table 1* (page 3) illustrate that some changes have taken place compared to last year. Overall, with the exception of agencies under $600,000, total compensation is up as a percentage of gross revenues. Employees are an agency's biggest resource and owners often cut other expenses before cutting people. With revenues down and no change in headcount, payroll expense as a percentage of gross revenue will increase even with pay freezes. The ratios reinforce this theory as agencies, with the exception of agencies between $1.5 million and $4.0 million, reduced their selling and operating expenses, while total compensation expenses as a percentage of gross revenues increased for agencies $600,000 and larger. We suspect agencies in the $1.5 to $4.0 million range may have maintained or increased their level of selling and operating expenditures in order to gain market share.

In addition to comparing your results with the appropriate peer group and your own historical performance, also compare your numbers with the Suggested 2010 Pro Forma Ratios, which reflect ratios for a well-managed agency. The Suggested Pro Forma EBITDA for 2010 is 23.8%, which is higher than the EBITDA any of the peer groups reflected. The key differences between the Peer Groups and the Suggested Pro Forma column are in Executive and Production Payroll and Total Administrative Expenses. Agency owners often split their time between the executive and production roles. The suggested Pro Forma Executive Payroll is 4.0% of gross revenues, but can vary from 2.5% to 5.0% of gross revenue, depending upon the size of the agency. In general, smaller agencies in revenue size will have a higher percentage allocated to executive payroll compared to larger revenue agencies. To arrive at a pro forma a third party buyer will remove excess owner compensation, which subsequently falls to EBITDA and the bottom line. For comparison purposes, it is a safe assumption that the average Executive Payroll and Production Payroll lines shown for Groups 1 though 4 include excess owner return, whereas the same lines in the Suggested Pro Forma 2010 Ratios column are adjusted to remove excess owner return.

A third party buyer will also adjust Total Administrative expenses simply reflecting approximately 1% of gross revenues in depreciation to account for capital replacement expenditures. Amortization expense would be eliminated from the Suggested Pro Forma Ratios as this is a non-cash expense. Officers' life insurance is not included, as a third party buyer would consider this a discretionary item. Interest expense is removed because an agency's ongoing liabilities are reflected on its balance sheet. Finally, miscellaneous administrative expense is not included, because this typically reflects severance payments, deferred compensation payments or other items that occur for a limited time or the outstanding obligation is already reflected on the agency's balance sheet.

When evaluating your agency's compensation expense ratios described above, it is also important to look closely at employee productivity numbers. The more commissions employees are capable of generating for each compensation dollar paid out, the higher the resulting profit margin. Agencies with higher levels of productivity will have more money available to provide the tools and facilities to help employees achieve higher growth rates and be even more productive and profitable.

At the bottom of *Table 1* the averages for each composite group are provided for Revenue Per Employee, Payroll Per Employee and Employee Marginal Profitability. To calculate Revenue Per Employee, divide your net revenues by the number of full-time equivalent employees. When determining the total number of full-time equivalent employees, count part-time employees as a portion of a person. For example, based on a 40-hour workweek, someone working an average of 20 hours per week would count as 0.50. Also, take into account new hires and terminated employees. If a full-time employee started July 1st or was terminated June 30th and your fiscal year is the calendar year, then count these individuals as 0.50 because they only worked half the year.

To calculate Payroll Per Employee, divide total payroll expense by the same number of full-time equivalent employees used in the Revenue Per Employee calculation. Do NOT include payroll taxes, employee benefits, etc. The Employee Marginal Profitability is the difference between Revenue Per Employee and Payroll Per Employee and represents the average contribution per person to profit and overhead. When making your comparisons to Peer Groups, take into account your particular situation. Differences can be caused by an agency's specialization or service structure. For example, if your agency is primarily personal lines and small commercial lines, the Revenue Per Employee figures will most likely be lower than average. If your agency

Table 1
Average Agency Income & Expense Composite Ratios for 2009 Suggested Pro Forma Ratios for 2010 Budget

	Actual 2009 Averages				
Agency Revenue Size Range:	**Group 1 Under $600,000**	**Group 2 $600,000 - $1,500,000**	**Group 3 $1,500,000 - $4,000,000**	**Group 4 Over $4,000,000**	**Suggested Pro Forma 2010 Ratios**
P-C Commissions	85.7%	78.9%	73.2%	70.7%	73.8%
Life & Group Commissions	7.1%	12.4%	14.7%	16.2%	16.0%
Fees	0.9%	0.3%	1.3%	2.4%	1.1%
Contingent Income	5.9%	7.8%	9.3%	9.2%	8.0%
Investments	0.1%	0.6%	0.8%	0.7%	0.6%
Miscellaneous	0.3%	0.0%	0.8%	0.9%	0.5%
GROSS REVENUES	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**
Less: Outside Commission Expense	1.2%	1.8%	1.3%	2.5%	1.2%
NET REVENUES	**98.8%**	**98.2%**	**98.7%**	**97.5%**	**98.8%**
EXPENSES					
Executive Payroll	7.6%	8.6%	7.0%	5.1%	4.0%
Production Payroll	27.6%	23.2%	25.2%	26.7%	23.3%
Service and Support Payroll	19.8%	22.6%	23.0%	22.5%	21.0%
Total Payroll	**55.0%**	**54.4%**	**55.3%**	**54.4%**	**48.3%**
Retirement Benefits	1.9%	2.1%	2.0%	2.0%	2.0%
Non-Retirement Benefits	7.5%	8.3%	8.5%	7.6%	7.3%
Total Benefits	9.4%	10.4%	10.4%	9.5%	9.3%
TOTAL COMPENSATION EXPENSE	**64.4%**	**64.8%**	**65.7%**	**63.9%**	**57.6%**
Travel and Entertainment	0.9%	1.6%	1.9%	1.1%	1.4%
Automobile	1.6%	0.6%	1.0%	1.1%	1.2%
Advertising and Promotion	1.7%	1.5%	1.6%	1.4%	1.1%
TOTAL SELLING EXPENSE	**4.2%**	**3.7%**	**4.5%**	**3.7%**	**3.7%**
Facilities	4.0%	2.8%	4.0%	3.9%	4.0%
Telephone	1.1%	1.1%	1.1%	0.8%	1.0%
Postage	0.6%	0.4%	0.5%	0.4%	0.6%
Office Supplies and Printing	1.2%	1.2%	1.0%	0.9%	1.0%
Dues, Subscriptions and Contributions	0.9%	0.8%	1.4%	0.9%	1.0%
Licenses and Miscellaneous Taxes	0.5%	0.6%	0.3%	0.3%	0.4%
Insurance (P&C and E&O)	2.1%	2.1%	1.6%	1.6%	1.6%
Professional Fees	0.9%	1.3%	1.3%	0.9%	1.1%
Equipment Rental and Maintenance	1.8%	2.4%	1.8%	1.6%	1.4%
Bad Debts	0.1%	0.1%	0.1%	0.2%	0.5%
Outside Services	0.8%	0.8%	1.4%	1.3%	1.0%
Miscellaneous Operating Expenses	0.3%	0.0%	0.2%	0.1%	0.1%
TOTAL OPERATING EXPENSE	**14.3%**	**13.6%**	**15.0%**	**12.8%**	**13.7%**
Depreciation of Tangible Assets	1.3%	0.9%	1.4%	1.1%	1.1%
Amortization of Intangible Assets	0.6%	2.9%	1.6%	1.8%	0.0%
Officers' Life & Disability Insurance	0.2%	0.0%	0.4%	0.3%	0.0%
Interest Expense	1.2%	0.5%	0.8%	1.1%	0.0%
Miscellaneous Administrative Expenses	0.6%	0.2%	0.5%	0.4%	0.0%
TOTAL ADMINISTRATIVE EXPENSE	**3.9%**	**4.5%**	**4.6%**	**4.7%**	**1.1%**
TOTAL EXPENSES	**86.8%**	**86.6%**	**89.7%**	**85.1%**	**76.1%**
REPORTED PRE-TAX PROFIT	**12.0%**	**11.6%**	**9.0%**	**12.4%**	**22.7%**
EBITDA	**15.1%**	**15.9%**	**12.8%**	**16.4%**	**23.8%**
Revenue Per Employee	$94,124	$113,992	$131,519	$141,695	$148,000
Payroll Per Employee (Sans Benefits)	$50,544	$62,012	$72,730	$77,082	$72,300
Employee Marginal Profitability	$43,579	$51,980	$58,789	$64,613	$75,700

primarily writes large commercial lines, you can anticipate higher than average performance. If your numbers are below average and it cannot be attributed to a particular situation, it may be an indication that you are overstaffed and/or an indication of poor workflow and procedures. The November MarshBerry Letter will contain detailed productivity numbers for the same four size peer groups that are in this month's newsletter and will help in your analysis of the productivity of your staff.

Balance Sheet Analysis

The balance sheet presents a snapshot of the firm's financial condition at a certain date. *Table 2* below presents the Key Balance Sheet Ratios for 2009 and the recommended ratios for a Well-Managed Agency. We recommend you take the average of the last four quarters of your agency's balance sheet and compute the ratios described in *Table 2* to compare your financial situation to both the Peer Group averages as well as the suggested guidelines.

When determining your Current Ratio, make sure current assets include anything that can be converted into cash within one year. If there are accounts receivable or notes receivable that you do not expect to collect within one year, they should not be included for comparison. Securities should be converted to market value if they are carried at cost. Current liabilities need to reflect the current portion of any long-term debt. The average current ratio in 2009 for all four peer groups exceeded the well-managed goal of 1.30:1.

The Receivable/Payable Ratio measures an agency's collection practices and ideally should be below 35%. The rapid collection of receivables maximizes the amount of cash an agency has available for temporary investment. A ratio greater than 100% indicates lost investment opportunity because you are using the agency's money to pay your insured's premiums. The Trust Ratio measures an agency's ability to meet account current payments owed to the insurance carriers. In our opinion, an agency's goal should be a minimum of 150%. If the Trust Ratio is below 100%, the agency is using its insureds' premiums to run agency operations.

A good indicator of an agency's balance sheet strength is the Tangible Net Worth Ratio. Tangible net worth measures the amount by which an agency's tangible assets (all assets excluding goodwill, expirations, customer lists, covenants) exceed its liabilities and is a key component of an agency's value. By retaining earnings thereby increasing tangible net worth, an agency will be providing the funds it will need to finance future growth, capital investment, and perpetuation. An agency should strive for a tangible net worth ratio of 20% or more. If you are planning on perpetuating internally, the ratio should be 25% or more in order to build enough capital to fund future buyouts, as fixed assets and notes to shareholders are not liquid assets and could show the agency is undercapitalized to perpetuate internally. The circumstances of the past 12 – 18 months reinforce the importance of operating profitably, retaining earnings, and maintaining or building a strong balance sheet.

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Table 2 - Key Balance Sheet Ratios - 2009

Agency Revenues:	Group 1 Under $600,000	Group 2 $600,000 - $1,500,000	Group 3 $1,500,000 - $4,000,000	Group 4 Over $4,000,000	Well-Managed Agency Goals
Current Ratio is obtained by dividing current assets by current liabilities which are those amounts due to others within a year (including the current portion of long-term debt). This ratio is an excellent measure of liquidity.	1.44:1	1.80:1	1.32:1	1.55:1	1.30:1
Receivable/Payable Ratio is obtained by dividing trade accounts receivable by company accounts payable, including pre-billed items. A low percentage suggests good collection practices and the availability of the premium float for investment.	36%	40%	42%	43%	<35%
Trust Ratio is obtained by adding the cash and collectible accounts receivable and dividing that number by the accounts payable to insurance companies, including pre-billed items. If the result is less than 100%, the agency may be out of trust.	165%	158%	176%	201%	>150%
Tangible Net Worth Ratio is the tangible net worth divided by Net Revenues. Tangible net worth is obtained by subtracting from stockholders' equity intangible assets such as goodwill, expirations, customer lists, and covenants.	11%	13%	15%	11%	>20%

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