THE MARSHBERRY LETTER

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Building a Strong Balance Sheet

MarshBerry has consistently advocated the need for a strong balance sheet, positioning us as contrarians to many other financial and investment consultants who have recommended distributing cash out of your agency. Historical critics of retaining agency earnings have cited reasons such as double taxation (particularly for C-Corps) and the conservative yield of cash balances compared to the real estate and equities markets as arguments against retaining earnings. "Real estate always appreciates!" and "The stock market will yield at least 10% over time!" were mantras we heard consistently. However, as the current recession has shown us, conventional wisdom does not always hold true. Real estate does in fact depreciate and most of our investment horizons may not be long enough to capture 10% yield from our stock market investments. While double taxation does remain a concern, we believe paying a little tax is a worthwhile expense when you consider the benefits of building your balance sheet by retaining earnings.

How do I know if my Balance Sheet is Weak?

MarshBerry uses four key ratios as indicators when analyzing an agency's balance sheet as noted in *Table 1* below.

If you find that you are below one or more of these targets, you are not alone. As of 12/31/2008, benchmarked data resulted in the following statistics:

- *18% of agencies had a tangible net worth deficit*
- *9% of agencies were out of trust*
- *18% of agencies had a working capital deficit*
- *5% of agencies had all three*

Using data from the MarshBerry database, *Charts 1 and 2* (page 2) show the average Tangible Net Worth Ratio and average Defensive Interval over the last six years broken down by size of agency. *Charts 3 and 4* (page 2) further illustrate balance sheet trends over the last 8 quarters for the entire database. The results of first quarter 2009 have shown improvement over the declining trends in 2008. However, these results should not create a false sense of optimism or security because they were driven by the receipt of contingent commissions and overrides. We're likely to see significant balance sheet erosion during the second, third and fourth quarters in 2009 and the percentages above are expected to increase.

MarshBerry forecasts that 17% of agencies will not survive the next five years. Why?

- *Thinly-capitalized balance sheet*
- *No growth*
- *No perpetuation plan or lack of capitalization to accomplish a perpetuation plan*

Table 1 - Key Ratios

Metric	Calculation	Target
Tangible Net Worth Ratio	Equity less Intangible Assets/Net Revenues	15-25% of net revenue
Working Capital Ratio	Average Current Assets less Average Current Liabilities/Net Revenues	20%
Defensive Interval	Working Capital/ (Total Expenses/365)	90 days
Trust Ratio	Cash + Investments + Insurance Accounts Receivable/Insurance Accounts Payable	1.0 or higher

Reminder!

Please take the time to complete the Confidential Agency Market & Financial Survey by June 26, 2009.

For additional forms or to complete the survey online, visit our website at www.MarshBerry.com

Or, if you prefer, submit your form via:

fax: 440-392-6577

e-mail: TheMarshBerryLetter@MarshBerry.com

U.S. Mail: 4420 Sherwin Road Willoughby, OH 44094

Thanks for participating!

Chart 1 - Tangible Net Worth Ratio

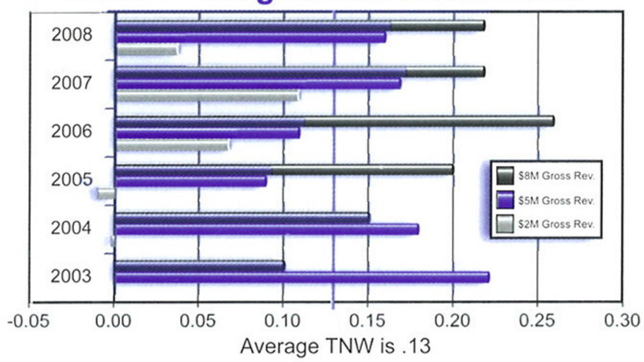


Chart 2 - Defensive Interval

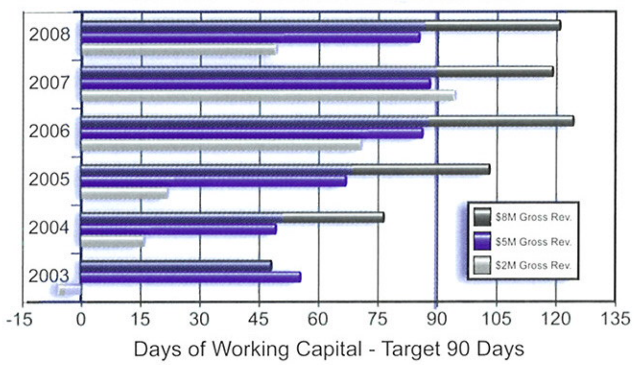


Chart 3 - Defensive Interval

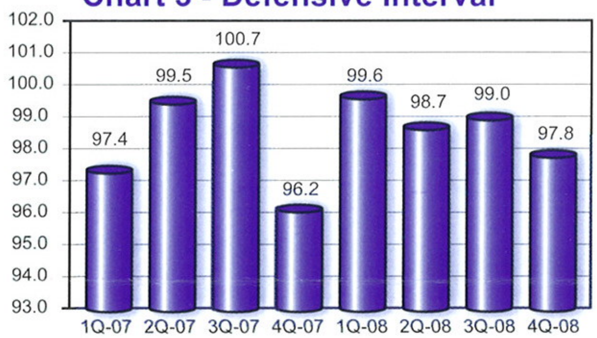
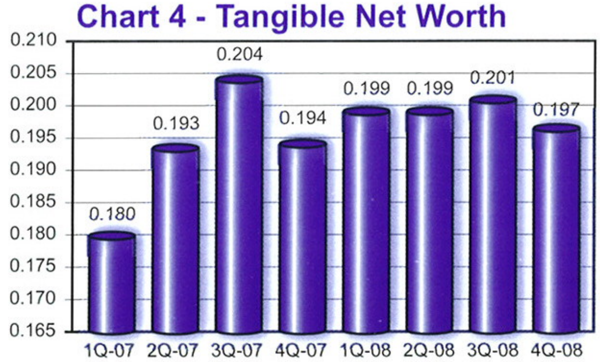


Chart 4 - Tangible Net Worth



Reasons to Retain Earnings

When determining strategy and business planning, agency owners must ask themselves a fundamental question: "Is my agency a lifestyle asset or am I building a company?" Neither answer is more correct than the other, but each philosophy will chart a dramatically different course for the agency. For those agency owners interested in building a company, retaining earnings is a critical component for multiple reasons:

1. ***Continued and consistent reinvestment in your most valuable asset - your agency.*** *Independent agencies have dramatically outpaced other investment returns in the past as illustrated in the last four years of MarshBerry Letters (August issues) in which we have shown the return on investment for independent agencies versus alternatives, including the Dow Jones, S&P and a Public Broker Composite.*

2. ***Flexibility when considering perpetuation options.*** *An agency cannot perpetuate without a strong balance sheet. Having retained earnings creates options for the transfer of ownership, such as providing the down payment for seller-financed notes, collateralizing corporate and personal notes, funding share repurchase liabilities and other financing tools.*

3. ***Swift action when considering producer hiring or reinvestment.*** *Good producers are difficult to find and can be even more difficult to land, so when the opportunities present themselves, having the resources to negotiate and execute create an advantage for your agency in the marketplace. The workforce has become increasingly savvy, often looking at the strength of the prospective employer's balance sheet as a differentiating criterion when selecting the right opportunity.*

4. ***Cushion against the impact of government involvement in insurance distribution.*** *The crystal ball is murky at best regarding the future of health care, although many would agree that insurance distributors will still have a role. However, will the product mix change? Will new products or services emerge? If so, will new technologies emerge to support these changes? Will the market create additional opportunities for acquisitions and growth? If the answer to any of these questions is "yes," the capitalized agency has a significant advantage when it comes to overcoming or even embracing these changes when postured against the agency that is thinly capitalized.*

5. ***Collateral or tangible assets necessary for bank borrowing and satisfaction of loan covenants.*** *The days of unsecured, uncollateralized, nonrecourse bank loans have gone by the wayside. Banks are now subjecting loan applicants to strict underwriting, imposing debt covenants and monitoring adherence to those terms and conditions. They are looking for assets to be pledged as collateral for loans. Banks are more likely to lend to those who have capital as opposed to those who do not.*

6. ***War chest for unforeseen needs.*** *We do not know how long this economic downturn will last and we do not have a clear vision as to what legislative changes may affect our industry. Do you have the balance sheet to persevere during a long-term recession or a dramatic shift in the delivery of insurance?*

How do I build my Balance Sheet?

When building a balance sheet, no one is suggesting that every dollar of profit be retained or that strengthening a balance sheet can be done overnight. Building a balance sheet is a long-term, ongoing commitment as an agency, not by individuals. Expect the process to take 3-5 years. Because of the time and discipline it takes to accumulate capital, spend the time necessary to plan, drawing the roadmap and continuously monitoring results. Set a time-line and tangible net worth ratio goal, estimate revenue growth and tax rates, and forecast how much capital must be retained each year to meet your objectives.

For those subscribers that also have a subscription to MarshBerry's Online Service, there is a Calculating Tool that can assist you in determining a retained earnings goal for your agency. It is called "Retained Earnings Calculator" and can be found in the Financial section.

Traditional Ideas for Building a Balance Sheet:

1. *Optimize workflow. When was the last time you scrutinized your processes? Have you updated systems and not procedures? Periodically auditing or validating that procedures are consistently followed will also help gauge the effectiveness of those procedures.*

2. *Invest in technology. People are an agency's largest cost. Consistently question how technology can help drive efficiency allowing your agency to become increasingly lean.*

3. *Optimize staff. An agency can cut staff, reduce or freeze pay or maintain the status quo while growing into the current staff by increasing revenue. The fourth "option," doing nothing, creates a drain on the balance sheet and erodes agency value.*

4. *Enforce producer accountability. Set minimum production requirements necessary to be called a producer, set goals that support and validate the agency's revenue targets, and establish a compensation plan that rewards overperformance and penalizes underperformance.*

5. *Assign profit/loss responsibility to department heads. Design budgets by department and assign metrics to department heads. Consider quarterly bonuses for hitting goals such as expense control, procedural adherence, retention, cross-selling and up-selling. All functional areas of an organization should have a vested interest in the financial performance of the agency and some influence over how to optimize that financial performance.*

6. *Set goals to retain targeted amounts. Whether choosing a flat dollar amount, a percentage of profit, contingent income, miscellaneous income, or investment income, make a commitment to earmark some level of revenue or profit to be retained by the agency.*

7. *Always be recruiting. Turnover costs can paralyze an agency. Continuously build and manage your pipeline of producers and service staff just as you build and manage your prospect pipeline.*

8. *Mentorship, education and training. Give staff the tools they need to succeed. Formalize a mentoring program for producers, service and support staff as well as training curricula for each. Formalizing training does not have to drain agency resources; it can be as simple as job shadowing and on-the-job exposure to more senior staff.*

9. *Institutionalize the strategy. Incorporate all levels of personnel.*

10. *Incentivize behavior. Quarterly bonuses for non-producing staff based on performance objectives that cascade from the business plan and agency objectives will help keep the staff focused and motivated. Annual bonuses tend to "get lost" in day-to-day activities for service teams, while quarterly bonuses keep the objectives and potential rewards fresh in each person's list of priorities.*

Creative Ideas for Building a Balance Sheet:

1. *Move all Agency Bill clients to ACH (automated clearing house) payment processing. While this is not easily accomplished, the benefits can be threefold. First, an agency can typically capture several days on the front end of premium collection and delay several days on the back end of premium remittance to maximize the opportunity to capture float. Second, even though interest rates are currently minimal, they are expected to rise. By looking at this option now, the agency can begin educating its clients and deepening its relationship with its bank, which can often lead to other favorable by-products (such as increased borrowing ability). Third, efficiencies are captured since the agency does not have to track receivables, collect checks, remotely capture or physically deposit premium checks.*
2. *Explain the direct bill commission receivable concept (often un-booked) to your banker. Once a bank understands the insurance distribution industry, and specifically the un-booked direct bill commission receivable, it will often consider that receivable as a part of your borrowing base, increasing the amount of loaned funds available to your agency.*
3. *Sell a book of business. While not always ideal, this can be a quick way to generate capital and increase operational efficiency.*
4. *Capital infusion. This option comes with a cost since it may involve personal funds, dilution of ownership and/or high cost private capital.*

Increase your Likelihood of Success

Building a balance sheet is a process that takes discipline and commitment. Involving the agency's Board of Directors or Executive Committee will help maintain the focus required to establish that discipline. Prioritizing the use of funds from the agency is an important step for ensuring all stakeholders are in agreement with the order of distribution of funds. Failing to build consensus during the business planning phase of the fiscal year often results in divisive personal interests within the agency as the year progresses. This may result in the agency not meeting its retained earnings' goal. Memorializing the prioritization of funds by way of a Board resolution is a powerful tool for managing adherence to the plan.

Agencies commonly place legal obligations as the highest priority for use of funds, followed by reinvestment in the firm, in its people, and finally in its owners.

Common Prioritization of Funds:

1. *Tax liabilities*
2. *Debt service*
3. *Non-owner/staff compensation merit raises and bonuses*
4. *Working capital/retained earnings*
5. *Profit sharing*
6. *Owner bonuses/distributions*

Limiting owner distributions to tax liabilities is an effective way to retain earnings, but often difficult to institute. The mindset has to be that the owners are interested in building the value of the agency, which is how they will be rewarded long-term. The owners can certainly take distributions beyond their tax liabilities, but only to the extent the agency has already achieved its retained earnings objective.

Rebuilding or strengthening a balance sheet does not happen overnight. The objectives must be tied to the business strategy, which must be monitored and adjusted as necessary throughout the year. Common mistakes made by agencies include cutting too deeply too quickly as well as suspending investments that are critical for growth.

The owners of the agency must lead by example. Do not hesitate to make sacrifices first before asking that of any others in your agencies. Communicate with your stakeholders and staff on a regular basis. The commitment is ongoing, so it must be cultural and systemic to be successful.

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