Dealmaker's Dialogue

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Internal and External Value: Narrowing the Gap

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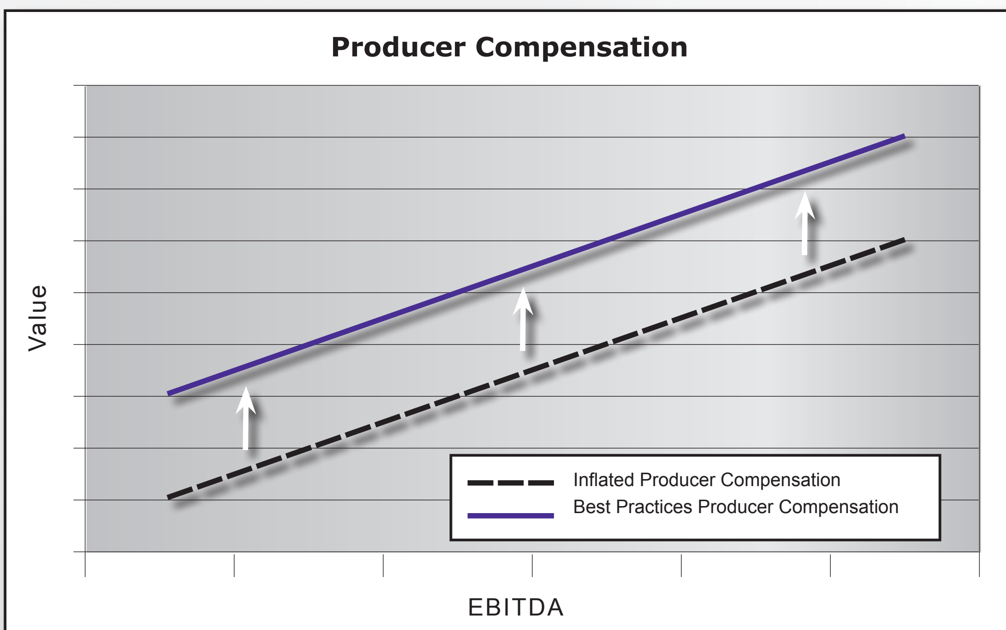
It is no secret that the value agencies use for internal perpetuation is usually much lower than the value attainable in an external sale. The difference is often chalked up to higher multiples that an external buyer will apply for strategic reasons. Higher multiples do play into the stronger valuations in an external sale, but an equally important factor is that agencies that sell externally achieve higher profitability than is the case in an internal perpetuation. Why is this? The single largest reason is that in an external sale, producer compensation percentages are more closely aligned with industry best practices.

Many agencies today operate with producer commission rates that include a renewal percentage five to ten points higher than industry best practices. Owners often struggle with making the difficult decisions necessary to bring compensation plans into alignment with such metrics. However, the external sale process focuses and motivates sellers to make compensation changes that they previously found difficult to embrace or implement.

The process of making compensation changes is indeed difficult and requires time, careful thought and a sound plan. However, not addressing inflated producer compensation is exactly what keeps such agencies from achieving the profitability levels necessary for higher valuations. Equally important, agencies with higher compensation are unable to generate the cash flow required to stay competitive in today's environment through reinvestments in areas such as new producer hires, pipeline management, automation solutions, marketing initiatives, etc. Significant cash flow is required to balance current owner return with investments in the next generation of producers and owners. Without investments in the next generation, perpetuation will fail.

In an external sale, the buyer will make changes to bring new and renewal commission percentages in line with their producer compensation structure. Traditional buyers have a lot of experience in this area, effectively helping owners make the difficult decisions. There are nuances to such an approach that we will address in a future Dealmaker's Dialogue, as these are not changes that can be made overnight. But when done correctly, compensation is "right sized" and the agency's true profitability is realized for the benefit of both the seller and the buyer.

Take for example an agency that currently pays producers a 40% new and 35% renewal structure. Considering typical expense metrics, chances are this agency will be able to produce EBITDA in the range of only 15% to 18%. However, if the renewal compensation is adjusted to a more reasonable 25% or 30%, EBITDA is effectively enhanced by between 5 and 10 percentage points. What other initiatives will you consider this coming year having that kind of long-term benefit to both owner return and survivability?



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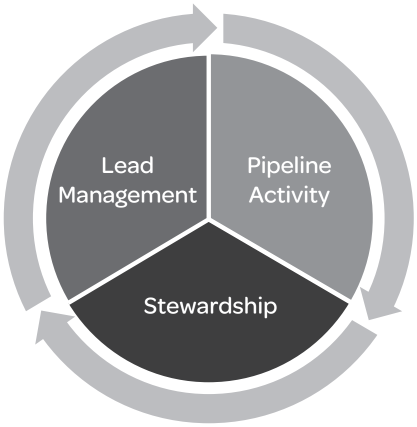

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The Sales Portal (formerly a MarshBerry product) is an innovative, web-based tool that automates all three aspects of the sales process: Lead Management, Pipeline Management, and Service Timeline and Stewardship Reporting.

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