

## Allstate Agency Value Index 2011 Year Review

In 2011 there were many active topics of discussion in the Allstate Community. Agency Terminations, Mergers and Acquisitions, Esurance along with the hottest of all topics: Variable Compensation.

### Variable Compensation and Agency Values

The biggest question I continue to be asked is “How will Variable Compensation affect agency values?”

The short answer to this question revolves around Allstate Insurance’s recent announcement that base pay for agents will be 9% in 2013 and 2014, instead of the originally proposed 8% base commission rate. This smaller than anticipated reduction in base commission matched with attainable incentives for getting back to a 10% commission rate will likely result in a marginal change in agency values, if any.

If you are like me the short answer doesn’t quite satisfy your curiosity. In digging deeper I think it is appropriate to look at how the market of buyers and sellers currently formulate an agreed upon price for an Allstate Agency. Then we can try to determine if and how Variable Compensation might affect the future value of Allstate Agencies.

In the Allstate world, the market of free-will Buyers and Sellers of Allstate Agencies have spoken loud and clear that Fixed Compensation holds a far superior value to variable compensation or bonus income. This makes sense under the current compensation structure as the requirements to hit a bonus change on an annual basis, with the one constant in an Allstate agency being 10% renewal commission income. In fact, bonus and other contingent income are not even part of the equation when discussions of price arise - I’ll support this theory with an everyday example:

If an agent calls me up and tells me they are selling their \$3,000,000 agency for 2.5 times, without additional inquiry, I know the purchase price is \$750,000:

$$\text{\$3,000,000 Earned Premium} \times 10\% \text{ base commission} \times 2.5 \text{ Multiple} = \text{\$750,000 Sales Price}$$

In this situation, the revenue of the agency may have been \$340,000+, with the inclusion of bonus and other miscellaneous income, however, this additional income is not included in the equation used to determine the final sales price.

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For comparison purposes, let's look at the housing market, where price per square foot is the rule of thumb that drives the price. Everyone wants to know what homes in their neighborhood are selling for on a per square foot basis. However, we all know that not all houses in a given neighborhood are created equally, since some have a more desirable floor plan, a bigger lot, or a pool. Yet, in any neighborhood, these "perks" rarely result in a top quality house selling for a significant amount over the going market price per square foot.

Allstate Agencies tend to realize the same restrictions with regard to potential sales price. Yes, an agency that is growing and has a good retention ratio will sell for more than an agency with poorer performance. However, the additional reward for an exceptional agency is minimal at the time of sale. Simply stated, my \$3,000,000 Earned Premium Agency will never sell for 2 or 3 times more than another Agency with the same Earned Premium. There may be a small additional benefit at closing for an agency that is likely to receive a big bonus and thrive under the new variable compensation program; however, any reward for running an exceptional agency must be realized by the owner during the time of ownership.

The absence of wild variations in the multiple for which Allstate Agencies sell is due to simple economic limitations. Regardless of how well a \$3,000,000 Agency performs in a given year, there is only so much cash flow available to support overhead, a wage to the owner and debt service associated with a purchase. Buyers simply cannot justify a purchase at a higher multiple, as it does not make economic sense.

*One cannot manage change. One can only be ahead of it. – Peter Drucker*

I'll conclude the Variable Compensation discussion with two notes:

1. I have a hard time envisioning any scenario where variable income will hold an equal or similar value to fixed/renewal income. The bottom line is not all dollars are created equally. Those commission dollars that are guaranteed will be superior in value to those earned on a contingency basis.
2. I see Variable Compensation as an opportunity. An opportunity vetted in greater income potential, but absent an opportunity to realize a greater price multiple that is in step with the efforts it took to create this additional income. Therefore, anyone buying into this line of thinking would be wise to create a fiscal environment in their business that has a healthy mix of business spending, personal spending and retirement savings. Don't put all your eggs in the future sale of your agency. From a time value of money perspective we all know a dollar saved today is more valuable than a dollar saved 20 years from now.

*In times of rapid change, experience could be your worst enemy. J. Paul Getty*

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## Mergers

Agency values in 2011 were affected in part by the allowance of merger transactions by Allstate Corporate.

Historically, choices were limited in their immediate geographic area for those who wanted to purchase an agency of \$3M or more in premium. Often, those agents desiring to buy a larger sized Allstate Agency were forced to settle for purchasing a smaller agency or investing in a start-up because organic growth was the only way to achieve their goal.

2011 presented a unique opportunity for both Outside Buyers and Existing Agency owners alike, as they were able to achieve scale by acquiring existing small or medium sized agencies that were purchased and merged. When you add the larger agencies available for sale, along with these merger opportunities, the market was suddenly saturated with opportunities to “get big” in a single transaction. This kind of opportunity has not been seen or realized since 2000 / 2001.

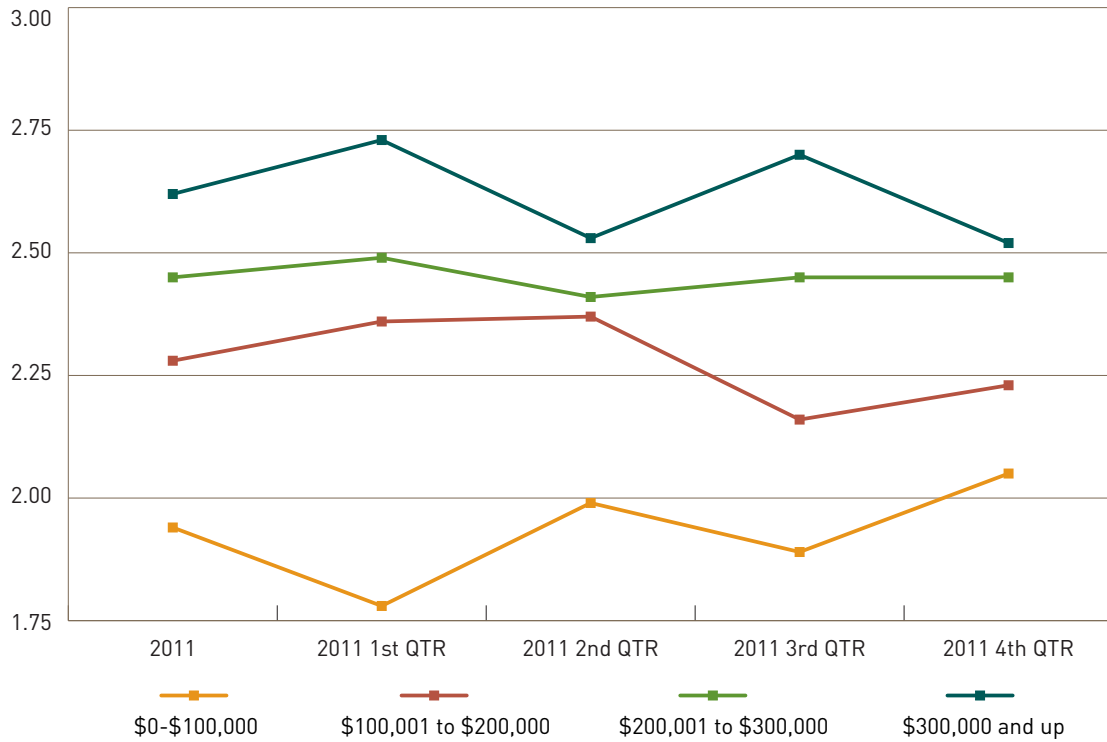
PPCLOAN was involved in over 200 agency transitions in 2011 and we saw this phenomenon first hand. Just over 70% of the agencies PPCLOAN was asked to finance were part of a merger transaction. Fifty-five percent of merger transactions were for Outside Buyers, with the remaining 45% going to Existing Agents who were allowed to purchase and merge their way to scale (again, a departure from historical expectations that growth should be primarily accomplished organically).

Allstate continues to work to attract new owners to the agency force. Sixty-eight percent of PPCLOAN’s agency financing transactions were to Outside Buyers, with 40% of those Outside Buyers buying a single agency location and the other 60% being allowed to purchase and merger multiple books (2-4 agencies).

Allstate Agency Price to Renewal Commissions Ratio (National Average)								
	2008	2009	2010	2011	2011 1st QTR	2011 2nd QTR	2011 3rd QTR	2011 4th QTR
\$0 to \$100,000	2.32	2.14	2.07	1.94	1.78	1.99	1.89	2.05
\$100,001 to \$200,000	2.41	2.35	2.29	2.28	2.36	2.37	2.16	2.23
\$200,001 to \$300,000	2.74	2.50	2.49	2.45	2.49	2.41	2.45	2.45
\$300,001 and up	3.13	2.78	2.79	2.62	2.73	2.53	2.70	2.52
Simple Average	2.71	2.46	2.41	2.33	2.47	2.33	2.25	2.34
Weighted Average	2.65	2.44	2.41	2.32	2.34	2.33	2.30	2.31

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Allstate Agency Value Ratios									
	2010 1st QTR	2010 2nd QTR	2010 3rd QTR	2010 4th QTR	2011	2011 1st QTR	2011 2nd QTR	2011 3rd QTR	2011 4th QTR
Agency Price to Renewal Commissions	2.39	2.37	2.43	2.41	2.33	2.47	2.33	2.25	2.34
Agency Price to Total Revenues	2.08	2.09	2.13	2.09	2.05	2.18	2.05	2.0	2.06

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## **Businesses are Meant to be Profitable**

I understand Allstate's desire to have its agents reinvest in their agencies in order to stimulate growth. I also understand the desire of individual agents to meet those goals set forth by Allstate, since doing so means greater commission income and job security.

However, I think some agents lose sight of the real goal in owning their own business, which is to maximize shareholder value. Yes, you are likely the only shareholder of your business, but that doesn't lessen the obligation to maximize your own shareholder wealth. Yet, many agents are busy maximizing shareholder value for Allstate Insurance at the expense of their own shareholder value.

I can hear NAPAA now. What about the threat of termination? What about quotas? I know about all this. I didn't say it was easy to maximize shareholder value for individual Allstate Agents. I am saying there are many agents who need to spend a lot more time developing a real plan for doing business, a plan that includes a healthy mix of meeting Allstate's goals while also maximizing personal income.

So, how is shareholder value maximized for an Allstate agent? This needs to be answered individually by each agency owner. However, I do know that spending nearly every penny you make on growing your business is not the way to maximize value. Living off of a spouse's wages and borrowing on a home equity loan or credit cards, with the hope of one day getting your money back on a sale, is not a smart strategy for maximizing your personal shareholder value.

## **Wealth in the Service Sector**

The most tried and true way to get wealthy owning a service sector business is through the accumulation of cash during your years and decades of ownership. Run the numbers and you will find this strategy produces a much higher return than putting all your hopes into getting top dollar for the sale of your agency.

Let's compare an Allstate Agency sale to a sale of a home in your neighborhood. Everyone wants to know what homes are selling for in their own neighborhood and the benchmark is the Price Per Square Foot. Most homes in a neighborhood will sell for just under or just over the average Price Per Square Foot for the area. Little increase is realized for having a highly desirable floor plan, a large lot, or a new pool. These "perks" need to have been enjoyed fully by the seller, because at the time of sale, you are unlikely to get your money back on these items.

The same is true for Allstate Agencies. A great retention ratio, low loss ratio or excellent business profit will result in some increase in price for the selling agent, but it will be nominal. This is the main reason why agents should take a good portion of their business profits to save for the future and diversify their wealth. Failure to do so will result in significant loss in value. As we have already determined, a well-run agency only realizes a nominal increase in the sale price, at best.

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## **Diversification**

What would you say if I told you to take all your free cash-flow, retirement and personal liquid savings and put it into a really hot stock that is a sure winner? Would you think I was crazy? I hope so. You might even mention diversification of wealth. And I would agree, however, I regularly see Allstate Agents with 80-90% of their personal net worth tied up in their Allstate Agency and it is usually a result of an extended period of “reinvesting all free capital back into the business.”

Don't get me wrong, I think Allstate Agencies are a great investment. I have assisted in lending over \$500 Million in Loans to Allstate Agencies. They are successful businesses that repay their loans on time. In fact, there may be a year or year(s) where neglecting retirement savings or wealth diversification in the name of “growing at all costs” may be a good short-term strategy. However, I can't see this as a one-size-fits-all long-term strategy.

## **Follow the Leader**

Allstate holds Investor Days, which provide commentary on how Allstate as a company is going to maximize shareholder value and why potential investors should invest in Allstate's stock. If you held an Investor Day, what would you say? Call me at (281) 419-0400 and let's practice. Do you think I would be interested in investing in your business? Or do you think I would hear a lot of talk that would be more for the ears of Allstate Management and less for someone wanting to invest in your business.

So, why all the fuss? Why am I talking about this subject? Because I know there are many great Allstate Agents out there who are struggling to survive. It's not because they paid too much for their agency. It's not because Allstate isn't competitive enough. It's because they keep banging their heads against the wall by not making wise decisions about how to run their business.

## **What's at Stake?**

I know how important an Allstate Agent's business is to its owner. It's personal, it's emotional and there is a lot on the line. These are not passive investments where an individual might be willing to “walk away” if things don't work out. The majority of Allstate Agents are self-employed and their agency serves as their sole source of income and the means by which they provide for their families. Let's all do some early year planning in 2012 and position ourselves to meet our personal, as well as Allstate's goals.

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