Q2 2016

OGP ID: 9999

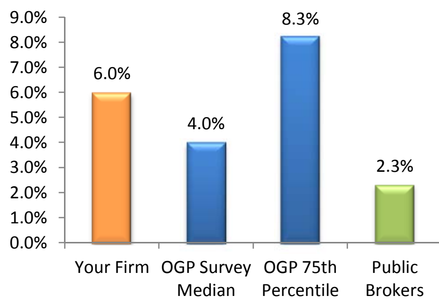
Current Value Driver Comparison

Organic Growth & Profitability Survey

Reagan Consulting

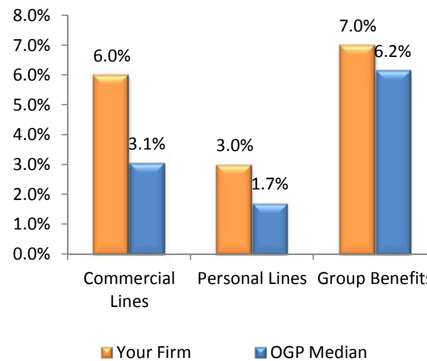
Organic Growth

Total Agency Organic Growth



Your organic growth rank:	50th - 60th percentile

Organic Growth by Product Line



Reagan Consulting Observations

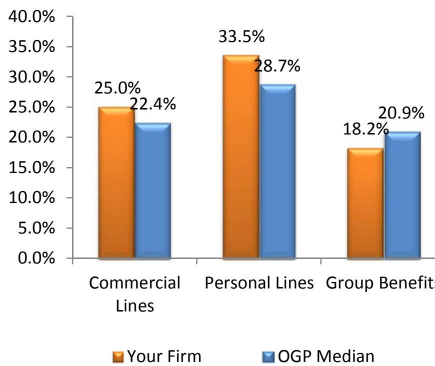
- Organic growth dropped to 4.0% in Q2, the lowest quarterly growth rate since 2011
- Commercial lines experienced the largest quarter-by-quarter decline in growth, falling from 5.1% in Q1 to 3.1% in Q2. However, growth weakened across all lines of business.
- One-quarter of OGP firms reported negative organic growth in Q2
- **OGP Projected 2016 Growth: 5.1%**
  Brokers expect growth to rebound to over 5.0% by year's end. However, the current 2016 full year projection is one point lower than what was expected at the start of 2016.

Profitability

Total Agency EBITDA Margin

Your profitability rank:	40th - 50th percentile

EBITDA Margin by Product Line



Reagan Consulting Observations

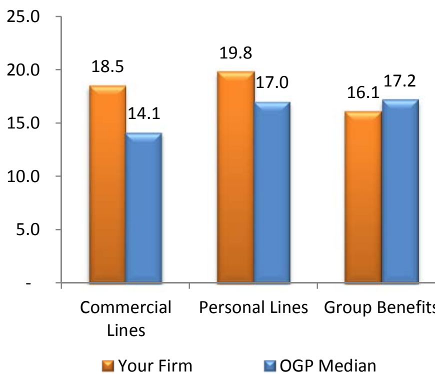
- EBITDA Margin decreased to 23.1% in Q2 2016, the lowest Q2 margin in four years
- Q2 2016 margin declined one point and a half versus Q2 2015, the largest year-over-year Q2 drop in OGP history. All lines of business experienced margin deterioration.
- Median EBITDA figures are inflated by the cash-basis recognition of contingent income, which is largely received in the first half. Thus, as in past years, EBITDA margins will decline throughout the course of 2016.
- **OGP Projected 2016 Margin: 20.0%**
  Despite the second quarter decline, brokers still expect EBITDA margin to stay constant from 2015 to 2016

The Rule of 20 (see note below)

Total Agency Rule of 20

Your Rule of 20 rank:	40th - 50th percentile

Rule of 20 by Product Line



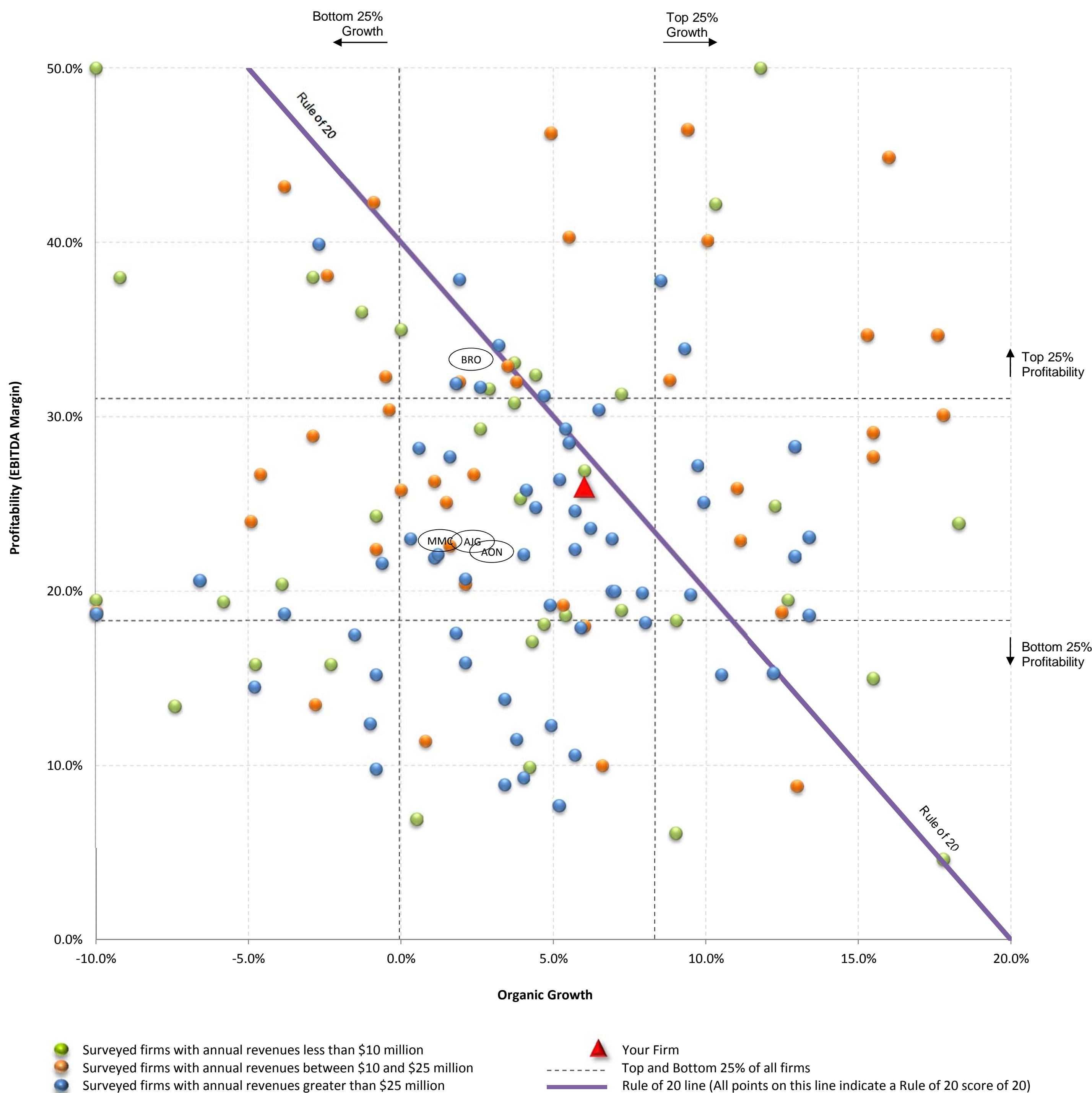
Reagan Consulting Observations

- The 16.7 median Rule of 20 score is the worst second quarter performance in the past five years
- Rule of 20 scores, like EBITDA margins, are inflated by cash-basis contingent income and will decline throughout the year
- Commercial lines Rule of 20 declined five points due to the slowdown in both growth and profitability. Group benefits and personal lines Rule of 20 both decreased also.
- **OGP Projected 2016 Score: 16.0**
  Brokers expect full year Rule of 20 to improve in 2016 (16.0) versus 2015 (14.7), although this appears optimistic

About the Rule of 20

Reagan Consulting has developed a metric called the “Rule of 20” to provide a quick means of benchmarking an agency's shareholder returns. The Rule of 20 is calculated by adding half of an agency's EBITDA margin to its organic revenue growth rate. An outcome of 20 or higher means an agency is likely generating, through profit distributions and / or share price appreciation, a shareholder return of approximately 15% - 17%, which is a typical agency / brokerage return under normal market conditions.

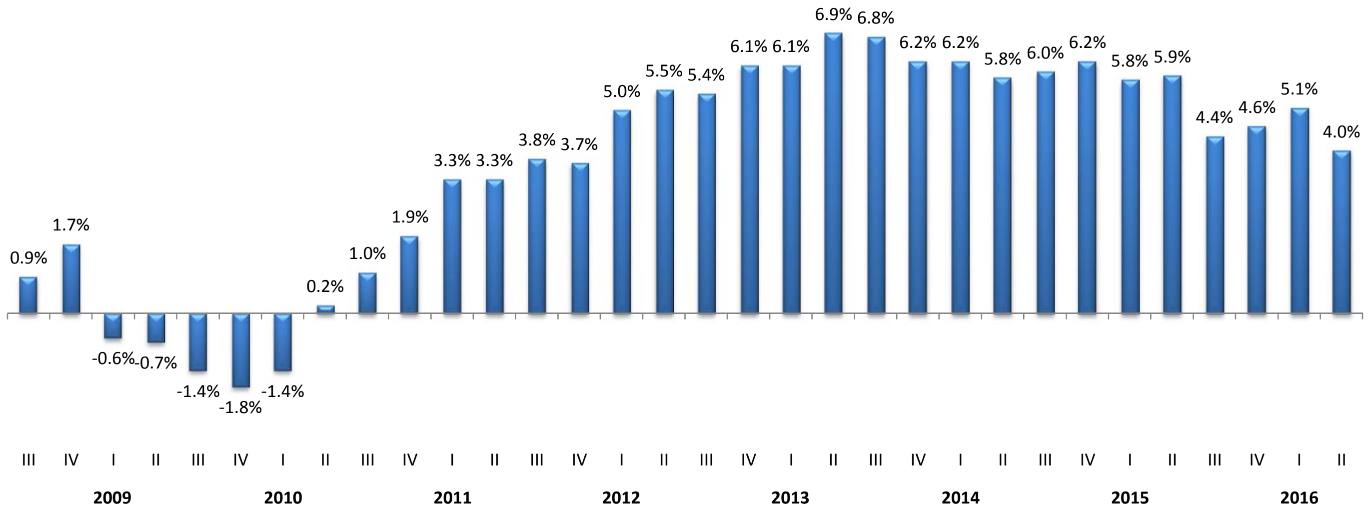
Note: If data for your firm reads "0.0%" or "0.0" it may mean that no data was submitted for that metric.



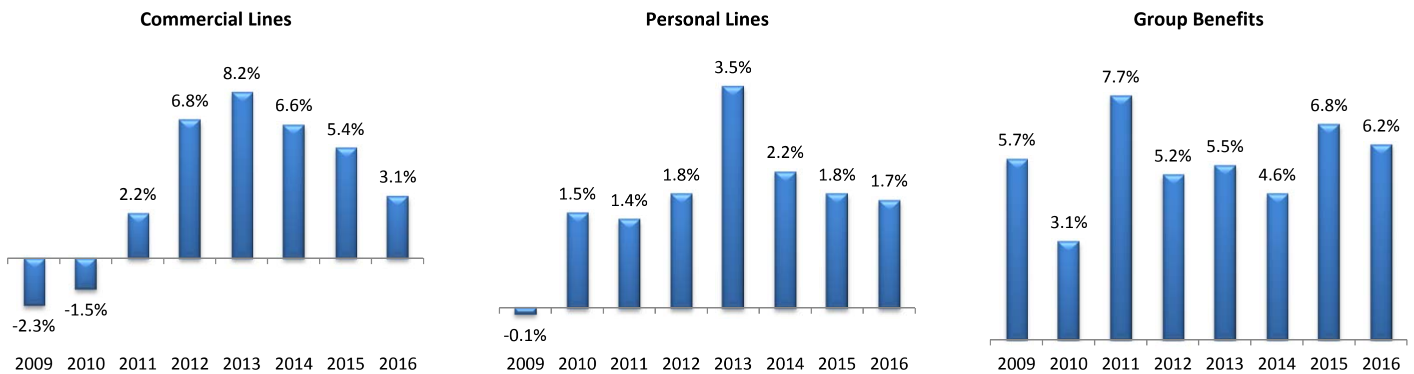
About the Scatter Plot

In the chart above, we've plotted every firm in the survey that completed both the total agency organic growth section and the total agency profitability section. Each firm's organic growth is plotted along the x-axis, and each firm's profitability is plotted along the y-axis. We've included a couple of guidelines on the graph to help in interpreting the data. The grey dotted lines show the top and bottom 25% of firms in organic growth and profitability. The solid purple line represents all combinations of organic growth and EBITDA margin that result in a Rule of 20 score of 20. Finally, we've broken the firms into groups based on revenue size, as distinguished by the different colored dots. The goal of this scatter plot is to show the wide range of organic growth and profitability results in the industry and to benchmark where your firm falls.

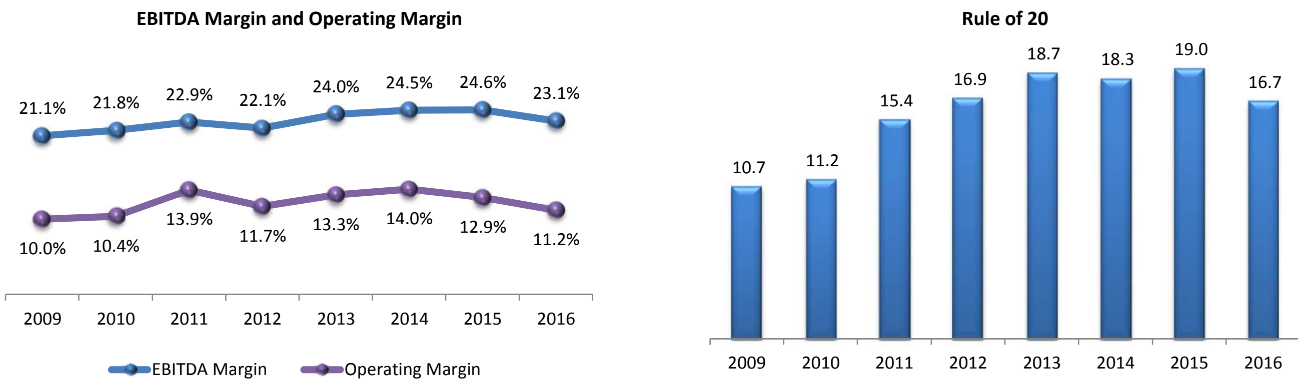
Quarterly Organic Growth - Total Agency Median (Q3 2008 - Present)



Comparative Median Organic Growth by Product Line (Second Quarter Numbers, 2009 - Present)



Comparative Median Profitability and Rule of 20 Analysis (Second Quarter Numbers, 2009 - Present)



About EBITDA Margin and Operating Margin

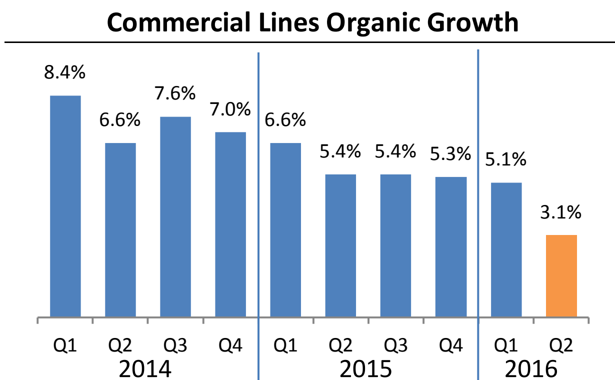
EBITDA Margin is calculated by dividing a firm's pro-forma EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) by the firm's pro-forma net revenues. Operating Margin is calculated as EBITDA less contingent income, divided by pro-forma net revenues less contingent income.

Commercial Lines Growth Struggling Against Persistent Headwinds

by Jim Campbell

Following a modest first quarter uptick, organic growth fell to 4.0% in the second quarter. This represents not only a sharp decline from the 5.9% achieved one year ago, but is the lowest organic growth rate posted since late 2011. It is also a continuation of a downward trend that began three years ago after organic growth reached a recent peak of 6.9%.

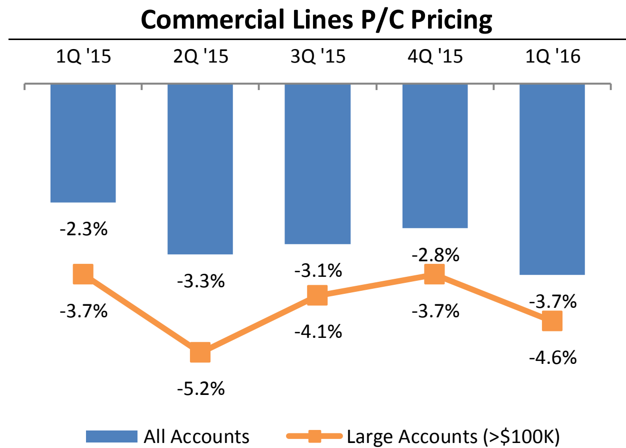
The culprit is not hard to find. The current decline in organic growth, as well as the persistent trend, has been led by deteriorating growth in commercial lines. Over the past ten quarters, commercial lines organic growth has fallen dramatically from the 8.4% achieved in the first quarter of 2014 to the current rate of 3.1%.



Perhaps most notable is the steep quarter-over-quarter decline. Over the previous four quarters, commercial lines organic growth slumped slightly from 5.4% to 5.1%. But in the second quarter, these modest quarterly ebbs gave way to a relative plunge, down to 3.1%. Is this a blip or a harbinger?

The answer will depend largely on the future direction of the two external forces that so heavily influence commercial lines growth: P&C pricing and economic growth.

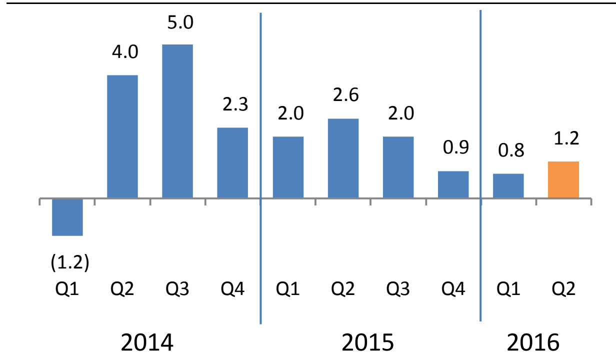
1) **P/C Pricing.** Based on survey results released by the Council of Insurance Agents & Brokers (CIAB), decreases in commercial P/C rates not only continued in the first quarter, but accelerated. The average decrease of (3.7%) was the largest decrease since the current softening trend began in 2014. And although rates decreased for accounts of all sizes, large accounts (>$100K) were most affected with an average decrease of (4.6%). It appears likely we will find pricing continued to soften through the second quarter.



2) **Economic Growth.** In a pattern becoming all too familiar, figures recently released by the Commerce Department show the US economy grew at only a 1.2% annualized rate during the second quarter. This follows a mere 0.8% advance for the prior quarter and falls well short of expectations. As captured succinctly by Joseph LaVorna, chief US economist at

Deutsche Bank Securities, "We're just muddling through."

Real GDP: % Change from Preceding Quarter



Source: U.S. Bureau of Economic Analysis

A softening P/C market and a muddling economy are hardly a formula for strong commercial lines growth. And although these headwinds have been present for more than a year, both are blowing stronger in 2016. Forecasting future trends for P/C pricing or economic growth is challenging. The uncertainty inherent in a presidential election year may partially explain disappointing economic growth through the second quarter. But only time will tell if the outcome of this year's election will be stimulative or contractionary. Expect organic growth generally and commercial lines growth specifically to languish until some recovery in P/C pricing and/or economic growth.

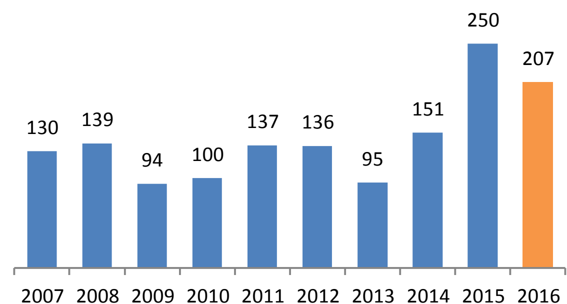
Fortunately, organic growth in employee benefits continues to provide a partial counterbalance to sluggish commercial lines growth. Second quarter organic growth in employee benefits was 6.2%, only slightly below the 6.8% posted a year ago and the second highest second quarter rate for employee benefits since 2011. For the second straight quarter, employee benefits was the fastest growing line of business, followed by commercial lines at 3.1% and personal lines at 1.7%.

As organic growth rates fell, profitability margins also showed some decline in the second quarter. The EBITDA Margin of 23.1% is the lowest second quarter margin reported since 2012 and is down from the 24.6% second quarter margin in 2015. More telling is the decline in Operating Margin, which excludes the effect of contingent income. The second quarter Operating Margin of 11.2% is the lowest since the 10.4% reported in 2010, and is down sharply from the 12.9% second quarter margin achieved last year. This year-over-year margin decline occurred in all lines, but was greatest in personal lines.

More encouraging, however, is the optimism shown in the full-year profitability forecasts. Despite the sluggish start, the projected 2016 year-end EBITDA Margin is a respectable 20.0% and, if achieved, would be generally consistent with the 20.1% margin achieved last year. Keep in mind, the decrease in the year-end projected margin relative to the second quarter margin is typical due to the nature of contingent income, which is both highly profitable and generally reported during the first quarter. As a result, YTD profitability margins decline through the calendar year.

So, as industry performance slumps, will there be broader ramifications? Could the M&A marketplace be affected? Last year was not only a record year for announced broker acquisitions, it eclipsed the previous record by more than 40%. And although deal activity this year has trailed the blistering pace set in 2015, we're still on track for the second most active transaction year on record.

Announced Agency Acquisition through Q2



Source: SNL Financial

In short, the robust marketplace continues. But will the current dip in performance give aggressive buyers reason for pause? After all, the current market is driven largely by private equity investors who are focused on achieving returns. Might decreases in organic growth and profit margins (the primary value drivers) cause concern about future returns? Will weakening performance be the trigger that begins to bring acquisition valuation multiples closer to historical norms? Not likely. The current M&A market is fueled by a combination of factors, including demographics, an abundance of available capital and low interest rates, just to name a few. Although a severe and prolonged deterioration in performance would certainly impact the market, a temporary performance dip should have little effect on buyer appetites.

As we move into the second half of 2016, the industry outlook remains strong. Organic growth is positive and profit margins are still near historical highs. Investment capital is flowing and valuations are high. But fasten your seat belts. Commercial P/C pricing and an uncertain economy will likely continue to challenge results in the near-term. Further weakening of either could make for a bumpy ride.

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