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Producer Compensation: Behind the Numbers

"How should we pay our producers?" The answer to this important question is not always simple.

- Service Staff **"GAIN AND PAIN"**
- Executive **COMPENSATION**
- Total Commission & Fees **PER SERVICE PERSON**

MAY | 2016

35TH ANNIVERSARY *helping clients learn, improve and realize their value*

May **Spotlight**

MGA, MGU, Wholesale & Program Manager Study: *Now Open*

MarshBerry is aiming to create insight into the wholesale broker, managing general agent (MGA), managing general underwriter (MGU) and program manager space through our exclusive 2016 **Market & Financial Outlook Study for Specialty Distributors** which is open now through June 3, 2016.

Your confidential responses will create, what we believe to be, a unique collection of data that seeks to answer questions specific to specialty distributors, such as:

- Do you know how your company compares financially to peers and competitors?
- How do your company's compensation costs compare to the industry?
- What are companies doing to prepare themselves for perpetuating ownership?

Results will be collected and aggregated (only averages will be presented) into a report that will be published in the fall of 2016. One complimentary download of the report will be available to companies that fully complete the study*. Both binding and non-binding authority financial perspectives will be presented. **No specific company results will be published or identifiable.**

The study, which should take less than 20 minutes to complete, should be completed by one of the following: Chief Executive Officer/President, Chief Financial Officer or Chief Operating Officer.

Take the survey now at
www.MarshBerry.com/2016isd.

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Producer Compensation: Behind the Numbers

“How should we pay our producers?” The answer to this important question is not always simple.

by ***Tommy McDonald,***
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40. 25.
The first two numbers you learn at MarshBerry: *40/25.*

Why? Because it's the answer to a vitally important and commonly asked question by leaders all over the country... *"How should we pay our producers?"*

For decades "40% on new and 25% on renewal" was the simple, short and direct answer to the question posed above. As the industry has evolved, roles and responsibilities have changed and technology has altered the way firms do business — so must producer compensation. Few agencies adapt their business model and corresponding compensation to adequately align with the long-term plan.

Not only is producer compensation your biggest annual expense, it is 100%, no doubt about it, the most important expense an agency will incur every year. And while the word "compensation" may invoke thoughts of boredom or low priority in the grand strategy, those that have been able to address this issue will flourish.

What we have learned is that once you peel back the onion on compensation and marry it with trended results, there is under-appreciated complexity hidden behind the numbers. The answer to the most important question is not as easy as 40%/25%.

A Story...

MarshBerry has worked with firms all over the country on better understanding long-term strategic goals around growth, profitability and perpetuation.

In most cases, compensation becomes a focal point to help leadership teams accomplish their goals. One recent engagement supports the notion that in order to truly understand best practices of producer compensation, you have to dig deeper.

Before we were engaged, here is what we knew:

- The firm was $15,000,000 in total revenue
- The firm's producer compensation split was 50% on new business and 35% on renewal business
- The firm employed 107 employees

Armed with this information, you can make the following basic industry benchmark statements:

- 50% on new business is 10% above the recommended 40%
- 35% is 10% above the recommended 25% on renewal
- The firm should be targeting $3,000,000 in new business

These data points also allow you to make a few assumptions about the firm's current challenges, one of which involves the agency's inability to produce even an average profit margin.

Assuming the agency has average expenses for customer service and support personnel, travel and entertainment, marketing, facilities, and other operating expenses, it would be hard to develop a best-in-class profitability margin of 30% when 35% of the residual is paid to the salesperson who generated the revenue.

> Not only is producer compensation your biggest annual expense, ***it is your most important.***

Another assumption lies around producer motivation.

Once you build a book of business, the higher the renewal commission, the less a producer is focused on new business. Regardless of how successful the firm was historically with regards to growth, once producers mature and their book stabilizes, there is a natural tendency to focus more on client management versus new business.

This agency is a perfect example of how important peeling back the onion can be in understanding the necessary context around compensation plans. After a strategic conversation with the leadership team, here were the variables that made our assumptions exactly what assumptions are: ideas that are accepted as true or as certain to happen, without proof.

Assumption #1:
The Same Commission is Being Paid to All Producers

MarshBerry has often recommended 25% on renewal across the board, but this agency actually ties its renewal commission based on book and account size.

The 35% on renewal is only available to producers who maintain a book of business in excess of $2,000,000 in Total Commission & Fees, and the 35% is only paid on accounts in the agency's large market segment where the account must generate in excess of $50,000 in revenues to the agency to qualify for this enhanced commission.

All producers with a $1,000,000 book or more in Total Commission & Fees receive a 30% commission rate on all accounts outside of those that fall into the Small Business Unit (SBU).

All producers with a book less than $1,000,000 receive a 25% commission rate on all accounts outside of those that fall into the SBU.

STRATEGY BEHIND THE NUMBERS:

The firm's growth plan involved incenting producers to move upstream and write larger accounts. The 35% renewal rate allowed the firm to manage a self-created new business minimum. Even the best of the best producers will lose revenue to natural book attrition. No one can adequately predict these "natural causes" to the book shrinking, but in order to break even or grow a $2M+ book of business, we would recommend that the producer focuses on a $400,000 new business goal with a $200,000 minimum to offset traditional 10% leakage in the book.

- **Today's Book Size**
  $2,000,000
- **12 Months Estimated Renewal Book Size**
  $1,800,000
- **New Business Target**
  $400,000
- **12 Months Estimated Total Book Size**
  $2,200,000
  ($2,000,000 - 10% of Revenue + New Business of $400,000 = $2,200,000)

Assumption #2:
Commissions are Paid to Producers on All New and Renewal Business

In contrast to brokerages that rely solely on producers to bring in new business, the agency has a well-established and fully staffed SBU that services all smaller customers, across all lines of business, across all industry verticals that represents $4,000,000 of the agency's revenue.

Any account that generates less than $10,000 in commission revenue is placed into this servicing unit and no producers receive renewal commission on this business.

STRATEGY BEHIND THE NUMBERS:

As much as the agency wanted to move upstream, the leadership team was not prepared to sell their small business or milk it to the point that became irrelevant. In order to provide the quality service platform needed in this area, they needed to deploy staff and invest in technology to help with the process. To make the math work, the firm needed to move commission away from the producers (who spent little to no time servicing this business and when they did spent little time prospecting). Raising the threshold and removing renewal commission allowed the firm to accomplish its goal.

Assumption #3:
Renewal Commission is Paid "No Matter What"

In the case of this specific agency, the minimum new business production standard for producers to receive their renewal commission amounts listed above based

METRIC OF THE **MONTH**

Total Commisions & Fees **Per Service Person**

Total Commissions & Fees per Service Person is a measure of the productivity of service staff. This ratio is a fair representation of the relationship between your service staff and the business they maintain, indicating whether or not your service staff is efficient. This is especially apparent when comparing organic growth and service staff compensation.

The graph to the right compares average Total Commissions & Fees per Service Person to Organic Growth based on three different groups.

The groups were generated from MarshBerry's proprietary financial management system Perspectives for High Performance ("PHP").

The size of the bubble indicates average service personnel payroll. The data shows that there is a direct correlation between the

on book tiers is $75,000 in new business. If a producer misses this minimum, the renewal commission received on their entire book drops by 3% in the first year with an opportunity to sell back their renewal rate to standard in the following year, which is updated on a rolling 12 month cycle.

STRATEGY BEHIND THE NUMBERS:

The firm's growth and success over its history allowed the leadership team to identify a theme. A small number of successful sales people were creating a significant amount of growth, new business, and value for the firm, while the majority of other sales people were not performing at a similar level. At this point all of the producers were essentially paid the same. In order to fix the problem, a simple approach was taken: ***Incent and properly compensate your top performers while protecting the agency from overpaying non-performers.***

Should a producer that generates $200,000 in new business per year be paid the same on renewal as a producer who generates $50,000 per year? The firm wanted to create expectations for performance and pay their best sales people the most, and protect the firm from not overpaying everyone else.

Assumption #5:
Legacy Books Create Profit

Agencies that have established a book transition plan often implement something relatively simple that moves a book from one set of hands to another.

In this circumstance, when a producer retires, the agency works diligently to transition the accounts and block of business as soon as the account is sold, introducing multiple people into the relationship management aspect of the service plan. This affords the agency with the opportunity to individually assign accounts based on size, niche and personality.

In some cases this transition creates the opportunity to move an account to a non-production servicing individual that is on a salary, giving this employee an opportunity to elevate in the company and take on more client-facing responsibilities. In turn, this strategy also has the advantage of not bogging down a sales-person with more renewal work. When a producer is given a transitioned account, the agency transitions at full renewal, but asks the receiving producer to trade down accounts in their current book to alleviate servicing responsibility.

Caveat:
New Business Goals Must Still Be Met

New business is so important. If goals are not met, the agency cannot support their high payroll for their strong service staff, world class facility and new employee investments. Due to the compensation structure on new business minimums, failure to reach a goal still allowed the agency to have a bigger margin to cover these costs. The agency also was able to support the new business expectation because of their SBU's ability to better service this customer, helping the producers open up capacity and provide a larger margin on small accounts.

Produce or Perish

The compensation variables listed above are examples of how firms have started to mold compensation programs to help align pay to agency-desired results.

This was a firm that was privately-held and aggressively working on internal perpetuation. The cash flow projection required the business to produce a profit margin that created a funding source for incoming shareholders that were purchasing stock. Each "buying" shareholder needed

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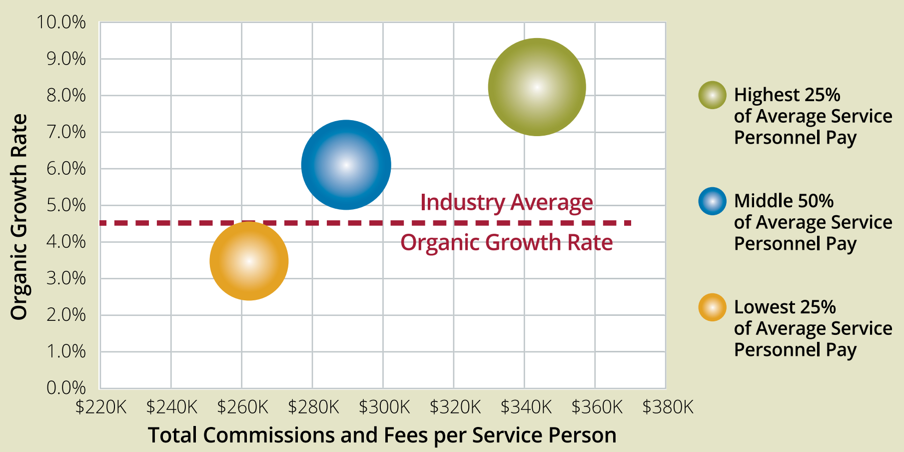
average service person pay and productivity of the service staff, as well as the organic growth of the agency.

Staff efficiency improves as average service payroll increases. The higher level of productivity consequently frees capacity for the production staff, allowing them to pursue more new business and drive organic growth.

Source: MarshBerry's proprietary benchmarking system, Perspectives for High Performance . "Average" is the average performance of all agencies in the dataset.

AVERAGE SERVICE PERSONNEL PRODUCTIVITY AND ORGANIC GROWTH RELATIVE TO SERVICE PERSONNEL PAY



Service Staff "Gain and Pain"

by ***Jim Wochele,*** Unit Manager, Sales Performance
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When your producers sell a new piece of business, do you get the impression that the service staff isn't as excited as the producers? It can seem natural since they didn't bring in the new business, but they're probably thinking "Great, more money for you and more work for me..."

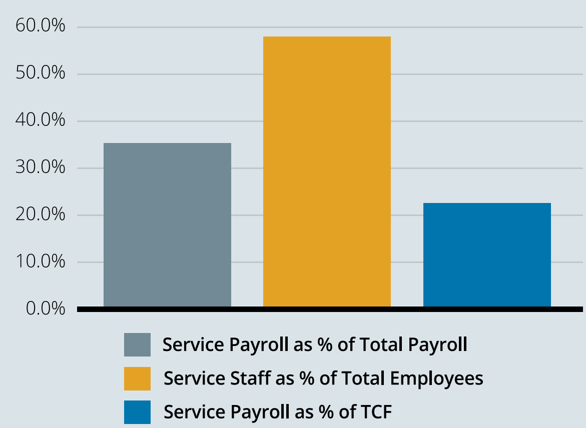
One reason for this attitude is a difference between producers and service staff. Keep in mind, according to MarshBerry's 2016 Agency Compensation Report, that service staff payroll is typically the second largest expense for an agency after producer payroll (averaging 22% of Total Commissions & Fees), and service personnel typically make up 58% of an agency's total staff.

Service staff compensation starts with the realization that their primary role is retention, and that they are driven by base salary, but are motivated by incentives. With that as a starting point, the service staff should have a plan that allows them to participate in the "gain and pain" of the agency's success, their team's success, and their personal achievements.

We suggest aligning and rewarding compensation to a combination of the following:

- **Company Goals:** growth goals, new business production goals, retention goals
- **Team Goals:** growth by department, new business by department, retention by department
- **Individual Goals:** growth of book of business handled, individual new business production, retention of their book of business, customer service results, service timeline and stewardship reporting commitments honored
- **Discretionary Goals:** subjective based on exceptional performance

2015 SERVICE COMPENSATION TRENDS



Source: 2016 MarshBerry Agency Compensation Report

Higher-level service members should be affected more than lower-level, transactional service employees:

	Portion of Total Compensation That is Incentive-Based
Account Executive	15% - 25%
Account Manager	10% - 20%
CSR/Support	5% - 12%

An Account Executive (AE) that manages a $1 Million book of business might have a target annual compensation amount of $125,000. That target can be made up of a

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the cash flow from earnings to offset tax liability for their K-1s and also to cover a portion of the debt service on the note held by the agency on the transaction. The firm also had to start storing excess earnings in the business to build funds to support selling shareholder buyouts in the next five years. The new business requirements allowed the firm to control their growth expectations to help to support the cash flow.

The agency's perpetuation efforts and cash flow projections, coupled with the valuation expectation from current and future owners, forced their compensation model to be rich for top performers so they could afford to cover debt service and purchase stock over the course of 10 years. This also protected the agency from overpaying poor performing sales people that would drain the margin needed to support the business' perpetuation. They are incenting growth in the book by paying based on book size and this maintains the focus on organic growth to keep the engine humming. In great profitability years, they distribute excess distributions to owners.

22/19/28

The last piece of information we received from the executive team before the meeting concluded was an annual report that is internally distributed to shareholders outlining historical trends in performance and the valuation overview that is conducted by a third-party appraiser every year. This report explains how the per-share value of the agency has been calculated, assessed and summarizes the results for the current year. The agency achieved the following results:

- **22% new business as percentage of prior year commission and fees which equates to $3,500,000 in new business;**
- **19% organic growth in total commission and fees from 2014 to 2015;**
- **Retention ratio of 97%;**
- **28% actual EBITDA (Earnings Before Interest, Taxes, Depreciation & Amortization) margin;**
- **4% of revenue wrapped up in new producer investments; and**
- **The agency hired eight new people into the service team in the last 18 months**

On the surface this agency's compensation plan is too rich, their new business is weak and their margin is stressed. Behind the numbers, however, this agency is producing "best of the best" results.

Are you overpaying your producers? Although some would be tempted to answer that question with the standard "40/25," the answer is rarely that simple.

Peer Exchange Network News

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Executive Compensation

by ***Mitch Mikoletic,***
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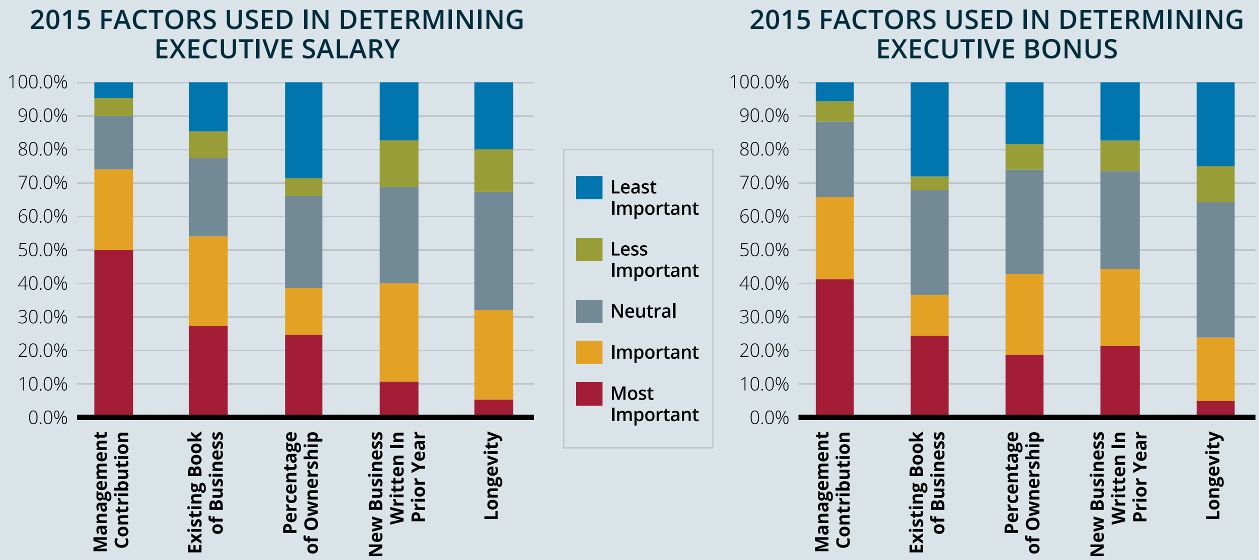
Developing and negotiating an executive compensation plan can be a challenge in any transaction — whether you are the buyer acquiring an agency or you're the shareholder/executive of an agency that's being acquired.

As a buyer, it is important that the selling shareholder will be paid a fair market compensation rate. If the buyer has to replace the shareholder (upon retirement or termination), the buyer will likely have to bring in someone new at prevailing market compensation. What a buyer does not want to happen a few years into the deal, is for the former shareholder to come back to the buyer and demand higher compensation (often, after the earn-out period has ended). Any increase in compensation at that point erodes the buyer's return on investment.



Source: 2016 MarshBerry Agency Compensation Report

As a seller, the amount and structure of executive compensation is important, since they want to be happy with the compensation post-closing (and feel they are being rewarded for their ongoing employment efforts). However, the seller should weigh the effects and balance between the compensation post-closing and how it impacts the valuation and purchase price.

Agency shareholder executives typically hold multiple roles in an agency; the two most common are executive management (CEO, President, etc.) and production (writing new business and managing a book of business). As a buyer or seller, one should evaluate the duties of the executive and what would need to be replaced, should this person leave the agency. Frequently, the compensation consists of a management salary and potential bonus, and commission on production (new and renewal). The commission percentages should be set at the appropriate rates for the agency (or market rates).

Setting executive compensation tends to be more of a challenge. We have seen that salary in addition to the production commission is most often appropriate, and some firms also pay a bonus for performance at a certain level. The base compensation for executive management is frequently set as a percentage of revenue. The salary plus bonus tends to run in the range of 1 - 5% of agency revenue. Although a very wide range, there are many factors that effect the percentage including size of agency, performance metrics and roles and responsibilities (to name a few). ■

It can be daunting for the buyer and seller to match the amount and structure of the compensation plan to the roles, responsibilities, and duties of the executive. ***But, it is an important component when managing towards a successful transaction.***

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base salary of $75,000 plus an incentive portion equal to 5% of monthly commissions. This AE would not only see the gain if new business goes into their book, but they would also feel the pain if they lose any business.

In this "gain and pain" culture, agencies can also provide commission income to service staff for selling new services and products (typically at a rate of about half that of a producer).

High performing agencies create a sales culture of accountability and reward by providing incentive compensation ***to all sales and service employees.***

For your service team, develop a plan that creates energy and excitement. It affects 58% of your employees to the tune of 22% of your Total Commissions & Fees. ■

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ON THE **HORIZON**

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06.27-29 **Emerging Leaders**
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AUGUST 2016

08.02 **Organic Growth Executive Seminar**
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OCTOBER 2016

10.06 **SalesPro Producer Training**
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MarshBerry's 2016 Market & Financial Overview report is now available. Learn more at **www.MarshBerry.com/2016MarketFinancial**

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