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Optimize in a Soft Market, Succeed in any Market Five Strategies for MGAs and MGUs

Soft markets can yield significant opportunities. While many in the marketplace relax underwriting standards and jeopardize future profitability, the next generation of successful firms will focus on optimizing operations and positioning themselves to pounce on the next hard market. For wholesalers, Managing General Agents (MGAs) and Managing General Underwriters (MGUs), achieving sustainable growth now not only leads to outsized profitability when the market hardens, it provides a platform from which to generate future returns – regardless of market conditions. The key may be to seek operational efficiency rather than short-term profits.

The Realities of a Soft Market

A soft market results in lower rates and depressed commissions. The most vexing problem in the industry, though, is that the majority of the players along the insurance chain are intent on managing the business cycle. Almost uniformly, they assume that markets will harden, but the cycle is rarely predictable. The market stayed soft through much of the 1990s, substantially longer than anybody expected. Further, the recent hard market was not as hard as it appeared. Following the 2004 Florida hurricanes and Katrina, Wilma and Rita in 2005, the capital that entered the market constrained rate increases and created additional capacity that fueled ongoing competition.

For MGAs and MGUs, the challenge of any market, hard or soft, is to manage the capacity to sell, process and service business. The resource needs of MGAs and MGUs can fluctuate dramatically based on the business cycle. However, they need to be sufficiently staffed and properly structured to assure top-quality service and profitable results. Managing these resources by the business cycle could force many MGAs and MGUs into a constant state of restructuring and turnover. Chasing an organizational structure leads to instability, increased costs and strained relationships with clients and trading partners. The solution may be to fine-tune the business for profitability regardless of market conditions. Preparing for a long-term soft market can protect profitability now and enable profit maximization when conditions become favorable.

There is no shortage of opportunity for business improvement when the market is soft. Five high-gain strategies include:

1. Business analysis
2. Operational assessment and enhancement
3. Business expansion and diversification
4. Positioning and preparation
5. Capitalization and investment

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Each strategy can lead to competitive advantage, making all of them attractive to MGAs and MGUs. However, attempting too much at one time, especially in a soft market, can be costly and unproductive. Implementing all five strategies concurrently almost guarantees that none will succeed. Instead, it makes more sense to select only the few that are most likely to yield the largest return, particularly if the time to realize the benefits is short. Risk is a factor as well. MGAs and MGUs may be more prudent to start with lower-risk initiatives. After a few early successes, more aggressive projects can be pursued.

Business Analysis

Changing market conditions often drive MGAs and MGUs to reexamine the products and services they offer, how they are distributed, their value-added propositions and the carriers to whom they are marketed. A willingness and ability to analyze the business during a soft market can provide a competitive advantage. Using the findings of this analysis will enable MGAs and MGUs to make decisions that will position their firms to outperform when conditions harden. Whether the business is ahead of the market or relying on dated practices, a careful eye on the business and a broad feel for the conditions surrounding it can lead to a competitive edge.

Productive business analysis requires both introspection and an understanding of the broader marketplace. Frank conversations with trusted advisors and a constant monitoring of market participants, including competitors, can lead to valuable market information. Information is the fuel of business analysis. Seeking outside advice is an uncomfortable proposition for many business owners unaccustomed to revealing their financials and inner workings. However, this is the wave of the future, especially as interdependence becomes the norm. With the knowledge gained, the firm will have a richer context from which to source and execute a growth plan.

Different perspectives are crucial when analyzing the business. It is best to assume that one will see what another will miss. To learn from themselves as well as from third-party professionals (including the competition), MGAs and MGUs will be better positioned to make informed decisions and increase their opportunities for success.

Operational Assessment and Enhancement

The effects of a soft market are quite predictable. Commissions drop, new business becomes more difficult to secure and renewals harder to retain. The competition for new clients is intense, and loyalty evaporates as existing clients search for lower rates. Meanwhile, resource requirements remain steady, at best. New hires and other investments in operations and enhanced capabilities may be necessary simply to maintain market share. Growth opportunities do exist; they simply require a new way of thinking. Mergers and acquisitions (M&A) may be the typical approach to soft market growth, but an investment in streamlining operations may be even more valuable. The cash outflows required for investments in growth opportunities are made easier when the existing expense model is under control.

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While business analysis yields understanding, action is the necessary next step. Assessing and enhancing operational capabilities can reduce overhead, which is particularly advantageous when commissions tighten and resource requirements are tested. With profits being squeezed, streamlining processing and eliminating waste through efficiency measures can bolster profitability. If an MGA or MGU can show an insurance carrier that it can earn them the same 15 percent return and charge 15 percent less than everyone else – while still making the same profit – everybody wins. The MGA or MGU becomes the premier service provider and the carrier's most profitable partner.

Operational Enhancement Opportunities:

- Implement new systems
- Update workflow and processing models
- Streamline billing, collections and accounting
- Identify new production sources
- Develop and execute an enhanced marketing plan
- Streamline underwriting, claims and premium audit processes
- Cultivate carrier relationships

There are a number of ways to improve operations, from new technology systems to streamlining underwriting, claim management and premium audit practices. While some measures can be costly (such as new systems and marketing), others involve little expenditure and can deliver substantial returns. Improving billing, collections and accounting, for example, can lead to improved cash flow and profitability.

Technology is key to improving operational efficiency. MGAs and MGUs will

need to interface with major production sources and key markets to provide an integrated business environment. The goal is to automate daily operations to the extent possible, and mine as much of the data being processed as possible. Ultimately, this should alleviate the need for manual work in completing routine tasks, reducing error ratios and improving service, all while building an invaluable database for ongoing analysis. Marketing, underwriting, processing, servicing and other activities will become increasingly intertwined with technology. While the benefits are attractive, the initial cost cannot be ignored. Implementing a technology-enhanced operation requires capital. This investment should reduce overhead and free the team's time to identify and cultivate new business opportunities yielding even higher returns.

Business Expansion and Diversification

Business expansion starts with revenue stream diversification. This could involve developing new revenue by growing existing business lines, adding new lines and classes of business or finding new sources of business. Other options include partnering with new markets and (in an increasing number of cases today) a well-planned and timely acquisition.

Small- and mid-sized MGAs and MGUs tend to rely on a few large production sources and only one or two insurance carriers for most of their revenue, usually in only one or a few lines of business. The natural result is the assumption of an inordinate amount of business risk. Losing one production source or one carrier market can threaten the viability of the firm. Diversifying the sources of revenue and market relationships are laudable goals, but are not easy. Simply selling more – or new – business is not a strategy that can be executed with the flip of a switch. It may be possible to find a market that could support lower-priced business, leading to increased business volume. However, this could distort future underwriting results and jeopardize the loyalty developed through long-standing relationships. To grow effectively without putting current relationships at risk, time and increased capabilities likely will be necessary.

Expanding the business can increase revenues, even in a soft market, while helping to block out the competition (particularly new entrants). A combination of new products and services, clients and markets can insulate the firm from a difficult operating environment and provide a substantial platform for growth. MGAs and MGUs can collaborate with production partners to determine products that complement those already in the firm's portfolio. The benefits are not free; investments of time and capital are required. In some cases, support from third-party service providers may be necessary to develop and implement an effective business expansion plan.

In a hard market, a focus on specialty classes or specific lines of business can pay substantial returns. Commissions are rich, and there are plenty of available opportunities. Specialization, under these conditions, tends to equal expertise, and it is rewarded. When the market softens, though, the rules change. Competition enters the space, eroding an already precarious market.

In the end, of course, diversification and expansion will change the business. Focusing on single lines brings simplicity as well as risk. MGAs and MGUs must be prepared to manage a portfolio of businesses under one umbrella, understanding that aspects of the operation may have to change. Whether deploying an M&A strategy or implementing a selective hiring process, new people with unique skills will have to fit into the practice, and their contributions need to be treated as more than ancillary.

Positioning and Preparation

Waiting for the market to harden may not be sufficient to ensure a return to growth when it does. Instead, MGAs and MGUs should use the current market to position themselves for rapid growth when conditions become more favorable. After all, preparation now can pay substantial returns later. Two areas with the greatest potential for returns are expanded market relationships and data control. Ultimately, the MGA or MGU needs to take measures that increase its control over its fate, and success favors those who prepare for it.

While their assistance may not be necessary in a soft market, new partners may deliver value when conditions harden. To this end, soft markets offer an opportunity to search for and develop relationships that may be useful in the future. Now is the time to find partners and new markets, particularly those with similar cultures, values and objectives. Relying on only a few markets, for example, can expose a firm to risk. Relationships often become strained when markets harden. Without alternatives, the MGA or MGU would be forced to rely on a partner at a time when the relationship may not be favorable. Diversification can protect the MGA's or MGU's ability to write business, and investing in new relationships now can provide choices when they are needed most.

Likewise, data needs to be collected and used to position the firm for outsized growth when the market hardens. In addition to analyzing existing data to find soft market expansion opportunities, data can be used to determine a hard market growth trajectory. Again, planning is crucial. Data collection is paramount when establishing a firm's Information Technology (IT) platform capabilities. Data needs to be collected, stored and interpreted. Such soft market planning can enhance hard market performance. In the end, it pays to be nimble when the time comes to make future decisions.

Positioning the firm for a future hard market entails a fundamental change in behavior. Instead of spending time reacting to market conditions, usually without any control over the outcome, MGAs and MGUs need to spend more time planning for the future. Consequently, they will have substantially increased control over the future.

Capitalization and Investment

Access to capital can constrain growth. New technology, hiring, market entry and acquisitions are among the strategic measures that require investment. Even with a clear benefit and a solid return on investment (ROI) justification, the deployment of cash is not a straightforward proposition. Self-financing, if possible, may be preferable as the capital is already on hand, but it requires that the firm have sufficient resources. Without a surplus, the firm will have to look to outside sources for support.

Self-financing is not as easy as it sounds. Especially for smaller firms, even the most compelling ROI cases are scrutinized. In fact, it is not unusual for owner/operators to pass on opportunities that could yield substantial returns. Outside capital, on the other hand, requires more sophistication than self-financing. In addition to structuring the infusion of capital, the firm will have to make the case for investment to outside investors. Fortunately, the current investment climate does favor the well-run MGA or MGU. Private Equity Intelligence, Ltd. (PREQIN), for example, pegs global uncommitted private equity capital at USD820 billion as of mid-2007, and private investors in general appear to have plenty of cash on the sidelines.

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The impacts of investment in company growth - either through self-financing or the use of outside capital - can be profound and long-lived. The capital itself is a catalyst, enabling the acquisition of new systems, distribution, companies and talent. Top-line growth can be attained without putting undue pressure on margins. The effects of outside investment are a bit more pronounced than those of self-financed initiatives. Interest payments may be necessary (for debt financing), and investors taking equity positions may expect dividend payments and at some point a liquidity event.

Conclusion

Eventually, the soft market dust will settle. The successful MGAs and MGUs will be those that retool now, finding efficiencies and preparing to take advantage of new opportunities for growth. Investing in enhanced capabilities while conditions are soft is intimidating. Resources are thin already; the decision to commit more to a possibly risky position, no less, is not trivial. While investing during a soft market may be risky, it could be more prudent than maintaining the status quo.

A failure to adapt simply gives the competition more room to maneuver, and you run the risk of being left behind!

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