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Valuation and Value Creation of Insurance Intermediaries

1 Introduction

1.1 Motivation and Objectives

The financial industry has been navigating through a perfect storm (Reinhart, Rogoff 2008; Haas, van Lelyveld 2014). It faced the burst of the tech bubble at the beginning of the century, the financial crises at the end of the decade, and is still affected by the current sovereign debt and European currency crisis. Yet the insurance sector has mastered the associated challenges fairly well. Most major insurers have managed to deliver solid performance and valuations over the last years¹. The same is true for insurance intermediaries. Despite repeatedly being declared a dying channel, insurance intermediaries are and have remained very much alive as the central distribution format in Europe as well as North America (Surminski 2002, 2003; McGranahan 2013).

However, the insurance intermediary business model has experienced numerous shifts from different directions. These include increased macro-economic challenges such as low interest rates, more stringent regulation, digitization as well as changing customer behaviour towards higher price sensitivity and use of multiple sales channels (Cummins, Rubio-Misas 2006; Cummins, Doherty 2006; McGranahan, Catlin 2011). The accumulation of these developments has intensified competitive density, led to margin reductions, and put pressure on insurers and intermediaries to seek ways to reduce costs and improve efficiency (Shim 2007, 2011). Else fulfilling the ever increased capital market expectations would not have been achieved.

In the long term, this uncertain mix of developments might affect all parts of the insurance intermediary value chain – on the economic as well as on the structural level – and will potentially cause massive change to the intermediary business model. Therefore, intermediaries must proactively face these challenges and turn them into business opportunities. This creates the necessity for intermediaries to identify those business activities that increase value and concentrate their efforts and resources towards them. Yet more times than not, intermediaries cannot articulate the actual value of their business, nor do they have a thorough understanding of the critical value drivers (Hales & Company 2011). Only the large global brokers have themselves oriented towards value, while the huge mass of small intermediaries has not undergone such an orientation.

With regard to academic research, insurance intermediaries are a relatively unexplored topic (Cummins, Doherty 2006). It is only since the late 1990s that a limited body of research slowly emerged for insurance sales (Bush, Grant 1994; Berger et al. 2000a; Moncrief et al. 2000; Goergen 2007). This literature, however, primarily

1 An exception to this, for example, is AIG. However, it may be argued that AIG has not incorporated a traditional insurance business model as for example Allianz, AXA, or Generali (Sjostrom 2009, Fromme 2014).

concentrated on insurers' perspective on the sales function, but did not focus on intermediaries themselves. Corporate finance research applied to insurance intermediaries is almost inexistent. With some exceptions (e.g., Cummins, Doherty (2006); Beenken et al. (2011)), most literature on insurance intermediaries is descriptive, only skims topics rudimental, and often origins from practitioners in industry-oriented journals.

The academic goal of this dissertation is to fill this void in the literature. It aims to enhance the research at the confluence of insurance sales and corporate finance. The practical objective of this thesis is to support insurance intermediaries in the identification of causes for action and the development of successful and sustainable business strategies. To achieve this, this thesis will explore four research questions that so far have not been addressed in a comprehensive and integrated way.

The first set of research questions in chapter 2 deals with the business model characteristics and market structure of insurance intermediaries. It lays the foundation for the three following self-standing perspectives on insurance intermediaries. The addressed research questions in chapter 2 are:

RQ1: What are the business model characteristics of the different types of insurance intermediaries? What is their market relevance and market structure? What are relevant trends and challenges in the industry and how should intermediaries address them?

Several industry developments (e.g., demographics, missing successors, and sharpened regulation) cause that an increasing number of insurance brokers will be forced to sell their business. At the same time no guideline on the valuation of brokers in a sale exists in Germany and traditional approaches can arguably not standardly be applied. Hence, chapter 3 addresses the following research questions:

RQ2: Do traditional valuation approaches need to be adapted for the valuation of small and medium-sized insurance brokers? Which valuation method(s) shall be applied and how do they need to be adapted? How is the valuation performed?

As the increased pressure for sale of smaller brokers meets the need of large brokers and investment companies to find growth and investment opportunities, the third set of research questions emerges:

RQ3: Do insurance intermediary M&A create value for acquirers? If yes, which factors determine the creation of value?

The last chapter reveals that large performance reserves exist in tied agent channels – evident from the enormous gaps in productivity and profitability not only between competing insurers, but also between agents within the same channel. Therefore, chapter 5 addresses the following research questions:

RQ4: How can tied agent channel performance be significantly and sustainably enhanced? Which primary drivers of sales performance exist? How should these drivers be addressed to lift the performance of average and lagging agencies to today's peak performance levels?

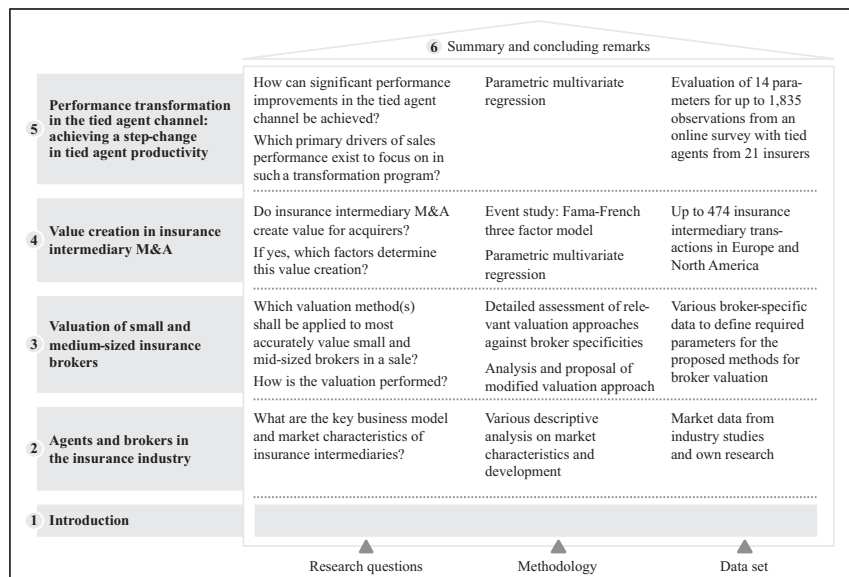
The addressed research questions contribute to the long tradition of valuation methodology, capital market, and success factor research applied to the under-researched area of insurance sales. This doctoral thesis is, therefore, relevant for researchers in the field of insurance, investments, sales, and corporate finance. For practitioners (e.g., intermediaries, insurance carriers, investors, and appraisers) this thesis presents several value-maximizing strategies. In detail, the four subsequent chapters are pertinent for academics and practitioners in the following areas:

- The *second chapter* presents an up-to-date market perspective. It draws the attention to the important trends and developments in the industry and recommends strategies to secure future growth. For academics, it features insurance intermediaries as an industry that is interesting for further research.
- The *third chapter* expands the valuation literature within the quite specific field of small professional service firms. For brokers, investors, and appraisers it offers a detailed description of a valuation approach specifically tailored to small and mid-sized brokers. In addition, brokers get insights on the factors that define the value of their business.
- In the *fourth chapter* M&A performance research in the financial services industry is extended to brokers as a representative of small privately held financial service firms – an area not addressed so far. For investors the chapter reveals whether such investments are value creating and points out which factors lead to value creation.
- The *fifth chapter* contributes to academic research by investigating performance drivers in insurance sales through the analysis of a large-scale proprietary data base. For practitioners, it draws up a systematic 4-step transformation program that aims at improving tied agent channel performance at double-digit rates.

1.2 Approach and Course of Analysis

The content of this dissertation is structured in six chapters (see figure 1). Chapters 2 to 5 each represent a self-standing study addressing the four sets of research questions presented. Thereby, the dissertation follows a multi-method approach, including qualitative and quantitative methods from corporate finance research. To answer the research questions, the thesis analyses two large data samples in chapter 4 and 5.

Figure 1: Course of analysis, applied methodology, and data sets of this doctoral thesis



Chapter 2 “agents and brokers in the insurance industry” introduces the insurance intermediary industry as basis for the analyses and elaborations following in the subsequent chapters. It differentiates the three types of insurance intermediaries (tied agents, multi-tied agents, and brokers) and describes their key activities and functions performed. Further, the chapter presents a market overview of this quite specific industry. It outlays the relevance of intermediaries in insurance distribution in Europe and North America, explains the key player categories, and summarizes the status of consolidation and competition in the industry. Lastly, it provides an overview on recent trends and developments in the industry. Thereby, it intends to create an understanding of the pressures to implement counteraction strategies to these challenges to secure future growth.

Chapter 3 “valuation of small and medium-sized insurance brokers” examines which valuation method(s) should be applied to most precisely measure the value of small and medium-sized brokers. The chapter starts with a number of foundations to set the basis for the analysis and elaborations on broker valuation. This includes the definition of value as well as the reasons and purpose of valuation investigated in the chapter (i.e., sale of the entire business as well as the business assets from the perspective of a “neutral referee”). Further, the fundamental valuation methods in the corporate finance literature are shortly outlined. These methods are then assessed for potential application and need for modification for the valuation of small and mid-sized insurance brokers. This review is undertaken by analysing valuation methods

and adaptations that have been suggested for small professional service firms by academics, practitioners and in case law on their suitability for broker valuation. As result of this analysis a modified valuation approach is proposed and outlined in detail.

Chapter 4 “value creation in the insurance intermediary M&A” explores the value creation effect of insurance intermediary M&A in North America and Europe. First, the chapter describes the M&A activity, status quo of consolidation, and the major acquirer groups in the insurance intermediary market. Thereafter, the theoretical background is reviewed and hypotheses on value creation potential and value determinants derived. It is argued that insurance intermediary M&A – in contrast to financial services M&A in general – achieve positive value gains for acquirers. To evaluate this hypothesis, the event study methodology is applied on a sample of 467 takeover announcements of insurance intermediaries between 2005 and 2013. Value determinants are then examined by application of parametric multivariate regression.

The final aspect of this thesis is analysed in *chapter 5 “performance transformation in the tied agent channel”*. It outlines a 4-step transformation program on how to capture a tied agent channel’s full performance potential. As critical step in the first phase of the transformation program “the analysis phase”, the chapter investigates the drivers of insurance agency performance. For this analysis, two performance measures are defined and evaluated by parametric multiple regression. Thereby, data of up to 1,835 tied agents are evaluated. Steps 2 to 4 of the transformation subsequently explain the measures to achieve the performance improvements and how to roll them out to the entire agency channel organization.

Chapter 6 summarizes the main findings of this doctoral thesis and highlights their implications for academic research and practitioners. It presents areas for further research and concludes with an outlook on potential developments.