Organic Growth & Profitability Survey

The Rule of 20

Balancing Growth & Profitability: Introducing The Rule of 20

Growth or profitability? Stock price appreciation or profit distributions? Agency owners frequently find that these objectives are at odds – especially in a soft market. To create growth, agencies must often invest in producers and resources, sacrificing short-term profits. Similarly, to drive profitability, agencies must often forego the spending that drives growth. How agencies balance growth and profitability ultimately determines the returns they create for their shareholders.

At Reagan Consulting, we see various approaches to this balancing act. Many agencies invest heavily in production talent and value-added resources to drive organic revenue growth. Other firms are content to grow at below-average rates in order to reap strong profits. Is one approach preferable? Which drives greater shareholder returns? What is the right balance?

We've performed extensive research to determine exactly what balance of growth and profitability is optimal for independent agencies and brokerages. What we've found is a relatively simple growth and profitability balancing equation that we call "The Rule of 20." The Rule of 20 states that an agency will drive acceptable shareholder returns if the sum of (a) its organic growth rate and (b) ½ of its EBITDA margin equals or exceeds 20. (EBITDA margin is defined as Earnings Before Interest, Taxes, Depreciation and Amortization, divided by Net Revenue.)

What are "acceptable shareholder returns?" By examining the cost of capital, we've estimated that an "acceptable" or "industry-standard" return for privately-held agencies and brokerages is approximately 15% - 17%. In other words, shareholders who are investing in these businesses want to earn 15% - 17% per year through either stock price appreciation and/or shareholder distributions. When we've tested the annual returns generated by different combinations of growth & profitability, we've found that any time The Rule of 20 is met (any time organic growth plus ½ of EBITDA margin equals 20) industry-standard returns are achieved.

Because organic growth is such a key input into the Rule of 20, the persisting soft market and the current depressed economic environment have made it very difficult to hit The Rule of 20. The median Rule of 20 score for the firms in the Organic Growth and Profitability (OGP) Survey during 2008 was 10.8, and only 10% of the firms in the OGP Survey had a Rule of 20 score of 20 or higher.

For independent agencies and brokerages, there are two applications of The Rule of 20: Benchmarking and Balance. First, an agency can quickly benchmark its shareholder returns by adding ½ its EBITDA margin to its organic growth rate. If this sum equals or exceeds 20, shareholder returns are meeting or exceeding industry-expected returns. If this sum exceeds 10.8, shareholder returns are above current median performance in the industry. Second, an agency can appropriately balance the trade-off between growth and profitability, understanding that two points of EBITDA margin are worth one point of revenue growth.

So, growth or profitability? The Rule of 20 indicates that there isn't one correct combination of the two, but that there are a variety of combinations that can generate similar, adequate returns. Every agency can find its appropriate mix depending on its capabilities, resources and aspirations.

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