



Cookson Walker Consulting

Payday at the Top

What's Your CEO Worth?

By Eric Walker and Paul Greenhow

In our industry, the topic of the softening commercial market seems to come up in many day-to-day conversations, along with a view of how long it will last, how far it will go!

If cash is king, then shareholder remuneration is the crown jewel! So then, for privately-owned insurance brokerages, why is the value of management's efforts obscure? What dollar number can be placed on the expertise and labour of the individuals responsible for the success of your company? Are these people replaceable, and at what cost?

The complexity of this issue is compounded by numerous factors, most notable of which is that shareholders of owner-operated brokerages typically perform many of the management functions.

As a significant shareholder, your compensation is ultimately based on the profitability of the company, whether it is in the form of salary, bonus, or appreciation of the value of the business. Your "pay" is essentially the profit that can be taken out of the business without compromising the future viability of the company.

Conversely, when attempting to place a value on your business, the compensation levels that are reflective of shareholder efforts affect company value. The fundamental value metric dictates that value is positively correlated to profits; i.e. the higher the profits, the higher the company value. As such, the higher the value you place on shareholder efforts, in terms of direct compensation (and thus adversely affecting profits), the lower the ultimate value of the brokerage.

Understanding the value of your company, and the corresponding value drivers, is critical to ensuring that your company's growth, profitability, and success are maximized. As many of you contemplate retirement (or if you just like to count your chickens before the hatch), tracking and maximizing the value of your largest asset is a prudent action.

When assessing the value of a brokerage (remember that value equals some multiple of profitability), shareholder remuneration is often the largest adjustment.

Reported and historical earnings are used as a guide to establish future profitability. Unusual or non-recurring items are eliminated from reported earnings, as are discretionary and non-arm's length (i.e. discretionary shareholder remuneration) income and expenses.

The reasonability of shareholder (management) compensation is dependant on numerous factors. These variables, some of which follow, must be taken into consideration in order to make a reasonable assessment of value.

- ◆ Controllable: Duties performed and responsibilities of the individual; relative contribution to company strategy.
- ◆ Somewhat controllable: Profitability of brokerage; size of brokerage; history of brokerage; company location.
- ◆ Uncontrollable: Economic environment; financing availability and rates and merger and acquisition levels; market cycle; what the competition is paying.

These factors cannot be considered alone and, of course, the strength of one can easily be offset by the weakness of another.

Unfortunately, there is no magic number or formula that can be provided, with a set of inputs that when sorted out will yield the economic value of an individual's time. Fortunately, there are numerous tools and processes available that will provide a concentrated range.

Benchmarks provide the most effective method of establishing a starting point. Benchmarks can come from various sources, including industry publications and surveys, consulting firms, executive search firms, querying your personal network, public company salaries, and probing financiers and equity investors who have a personal stake in top-level compensation.

The challenge with the insurance brokerage industry is that the vast majority of players in the Canadian market are privately-held companies from which information is not publicly available.

Broker publications and surveys on manager compensation are scarce and costly, consulting forms' price points often do not cater to the budget of the average broker, and search firms have a natural bias to inflate compensation levels. Depending on the trust within your personal network there may be opportunity to obtain information; however, one must consider the golden rule – “do unto others as you would have others do unto you.” Financiers and equity investors also have a vested interest in keeping their benchmarks and proprietary information held tightly.

This leaves us to discuss the levels of public company salaries. Compensation arrangements for public company executives should be viewed with discretion although they do provide some insight into how executives are paid for work performed. On average, public companies are much larger and have higher levels of profits with which to pay their top executives. In addition, public and shareholder scrutiny, board policy and tough expectations provide higher risk and exposure for public executives, warranting premium compensation. In isolation, executive pay positively correlates with company size.

The median CEO compensation for Fortune 500 companies in 2003 was \$7.1 million (US), or 282 times the average worker salary, up from 42 times in 1982. Bonuses for CEO's at the top companies in the United States rose nearly 50 per cent last year. In

Canada, the Ontario Teachers Pension Plan more than doubled executive pay with bonuses tripling because of exceptional performance – namely, beating industry benchmarks.

While those numbers reflect corporate America, a more direct comparison would be to look at the executive salaries of publicly-owned Canadian insurance brokerages. The executive salaries paid by Anthony Clark International Insurance Brokers Ltd., Hub International Ltd. And Western Financial Group Inc. ranged from about \$100,000 to more than \$2 million during the years 2001 to 2004, with the average being nearly \$700,000 and an annual increase of approximately 20 per cent. On the average, about half of the remuneration was received as salary and the other half as a bonus. These amounts exclude remuneration in the form of restricted shares and options.

To broaden the scope of review, one could look to comparable sized companies in the Canadian public markets (revenues of \$2.5 million to \$5.5 million). While no companies meeting this parameter were involved in the insurance industry, several operate in the financial services sector and non-manufacturing service industries. Based on a sample review of 25 public company information circulars, CEO cash pay (excluding remuneration in the form of restricted shares and options) for the years 2002 to 2004 was below \$300,000 in all but two companies, with an average of about \$160,000 in 2004. As a benchmark against revenue, the above noted results equate to an average executive pay in the range of 3 per cent to 4 per cent of revenues.

Company growth and profit levels, life cycle stage of the company, existing executive shareholdings, stock options, restricted shares, negotiated salary guarantees and golden parachutes all affect the relevance of the above averages.

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