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Creating a 'Win-Win' in M&A, Part IV: BB&T's Strategy for Buying Nonbanks

John A. Allison
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The cost savings for BB&T were in the backrooms of the [insurance] agencies, which were typically not efficient and were often viewed as a hassle for the sales-dedicated owners. We offered better systems and worked hard to be fair to any displaced employees.

Also, as we continued to roll up agencies, the insurance companies whose products we sold took notice because they realized the traditional agency system was not efficient and that we had developed a better model. We began to be able to negotiate better deals with the insurance companies, which allowed us to be more competitive in driving revenue (and sales incentive for employees) for the acquired agencies.

Furthermore, some of the agencies we acquired had a specialty in a specific insurance product. We could cross-refer from the other agencies driving revenue growth.

Initially we had expected that it would be easy to cross-sell our banking clients basic insurance products. This turned out to be far more difficult to execute than expected. In fact, most banks that entered the insurance agency business failed because they focused too much on selling to banking clients and did not achieve scale to leverage the insurance companies.

One reason cross-selling was difficult is because bankers tended to refer the wrong clients to the insurance agencies. The banking clients that were the most willing to talk to the agency were the ones who had problems getting insurance (maybe they had a DWI on their driving record). Over time, BB&T has radically improved its cross-sell effectiveness, but there is a long learning curve for both bankers and agents. The key decision early on was to focus on having a world-class insurance agency system and then to drive cross-selling. If we truly were able to deliver better insurance products and services to our banking clients, then the cross-sell would naturally follow.

BB&T's initial acquisitions were local property and casualty insurance agencies. Subsequently, we made a critical strategic decision to acquire a large wholesale broker, which took our agency system to a higher plane. A wholesale broker helps local agencies place insurance that is difficult to underwrite, because the wholesale broker has developed relationships with specialty insurance carriers and can deliver enough volume to allow the carrier to diversify within a higher-risk portfolio. We also acquired a managing general underwriter (MGU). This is another specialty niche where the MGU has such skilled underwriters that big insurance companies like Berkshire

Hathaway allow the MGU to underwrite the risk even though the insurance company assumes the risk.

BB&T recently acquired a large wholesale life insurance broker and now operates the second-largest property and casualty wholesale insurance broker and the largest life insurance wholesale insurance broker in the United States. The retail agencies feed business to the wholesale brokers, who also serve many other retail brokers. The combination has taken BB&T from a small town farm agency in 1989 to the sixth-largest insurance distributor in the world currently. The diversification of income created by the insurance agency business helped BB&T's performance during the recent financial crisis, as anticipated.

In addition, as a complementary business, BB&T has made acquisitions in the insurance premium finance business, becoming the second-largest insurance premium financer in the United States and the largest in Canada.

The real architect of this very successful and well-executed acquisition program is Wade Reece, a North Carolina "country boy." Here is a story about Wade that you may find interesting. We had unsuccessfully tried to hire leadership from the insurance broker industry to manage our agency acquisition program. After failing with outside hires, we decided to turn to a proven banking manager. When I visited with Wade without disclosing my long-term goals, I asked him what he thought of our insurance business. He said it "stunk" and did not have a future. After we convinced him that he would be given complete latitude to make necessary changes and would be totally supported by executive management, he later agreed to take over the agency system. About eight weeks after he started managing the system, I asked him what he thought. He said there was great potential and the agency system had a bright future — a very appropriate change in attitude and perspective.

The final acquisition area is noninsurance, nonbank acquisitions, again driven by an effort to diversify income. We made a conscious decision to do 10 small-venture capital acquisitions of financially related businesses including considering our clients who were in financially related businesses. Several of the acquisitions failed. Some were mediocre. Two turned into home runs.

One of the home runs is an interesting story. BB&T purchased a subprime automobile finance company at exactly the wrong time in the credit cycle. Prime-grade auto finance is one of BB&T's core businesses, and we thought there would be synergies between the prime and subprime businesses. The owner of the subprime business was very smart, and he saw the correction coming and sold at the peak. Be careful in buying a business from someone who knows a lot more about the industry than you do. The key to success in the industry is to be sure the borrower makes a substantial down payment, because default rates will inevitably be high. Also, a substantial interest rate must be charged, because there will be significant credit losses.

Because the subprime auto business had been making record profits, competition had intensified and down-payment requirements were reduced and interest rates cut. When the shakeout came, losses were far more than anticipated. By the way, the primary culprit in creating problems reflected in the automobile industry during the recent financial crisis was GMAC (now Ally), the one-time auto finance arm of General Motors, which has been bailed out twice by U.S.

taxpayers. GMAC, in order to sell cars, started providing low-down-payment, low-interest-rate financing to subprime borrowers, ultimately driving high defaults, helping create a bubble in the auto markets, which crushed the auto industry. Of course, since GMAC (Ally) has been bailed out by the taxpayers, it will certainly make the same mistakes again — you can bet on it.

Anyway, for over 10 years, every time I made the report described earlier on the performance of our acquisitions to our board, it was necessary to describe this merger as a "disaster." There was legitimate pressure from the board and some members of executive management to sell the business. In fact, First Union (which became Wachovia) had purchased a significantly larger but similar business; it liquidated that business and lost 100% of its investment.

We stuck with the business, consistently improving our management and processes until we unquestionably became the best underwriter and most efficient competitor in the business. I believed that this was a good business long term because in our type of market our client base needed to be able to finance a car to get to work. Many Hispanic immigrants in particular had not established credit scores, and without a legitimate subprime auto lender they would not be able to purchase transportation.

Over time our irrational competitors failed one by one, and we grew our business. In recent years, this product line has made a very significant contribution to BB&T's financial performance. Is there a lesson in this story? There are certainly times to exit businesses. However, one of BB&T's core strengths is outstanding operations. Assuming your organization has financial staying power, if you are in an industry in which being a world-class operator can create competitive advantage and the product serves a legitimate need, running the business extremely well will produce satisfactory results, as irrational competitors will eventually exit. Let the other firm make the big mistakes. Do not let incompetent competitors incent you to do anything irrational.

I hope you can see a series of organizational leadership insights in these stories. Strategy matters, process matters, rational decision making matters, but it all must come together through the excellent integration of the human beings involved in the process. Doing your best to create a win-win environment for as many partners as possible leads to success.

Are there any societal implications for the merger activities just described? I think there is a general lesson. For partnerships to work, they must be based on voluntary agreements. You may say that the employees of the companies we acquired did not always volunteer to be acquired. True, but they had the option of leaving. The employees who stayed volunteered to stay.

John Allison is the president and CEO of the Cato Institute and a former chairman and CEO of BB&T. This article is adapted from his latest book, "The Leadership Crisis and the Free Market Cure: Why the Future of Business Depends on the Return of Life, Liberty and the Pursuit of Happiness."