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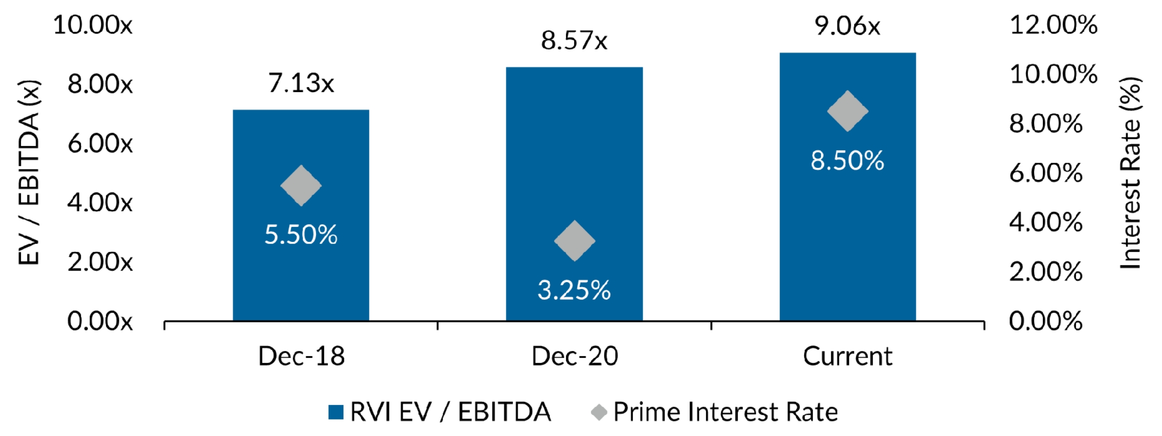
Interest Rates are Stress Testing Internal Perpetuation

Preserving the affordability of an agency's stock is key for internal perpetuation. However, rising interest rates are challenging the affordability of an agency's valuation.

Prior to June 2022, the cost of debt was nearly free, with interest rates around 3-4%. Today, the Prime Rate is 8.5%, a level not seen since 2001. The chart below compares agency valuations in our Reagan Value Index ("RVI") to the Prime Interest Rate. The RVI is a select group of approximately 35 privately held independent agencies, that Reagan appraises annually, with average revenues of $28 million. From 2018 to today, the RVI Enterprise Value / EBITDA, a common valuation metric, increased 27.1% while interest rates increased 54.5% over the same period. The combination of these two factors is stress testing stock affordability and causing concerned agency leaders to ask, "What immediate and actionable plans can we take to enhance affordability"?



When Reagan published the Private Ownership Study in 2010, roughly 59% of firms were financing stock purchases internally (agency financing or seller-direct financing). As interest rates have dropped in recent years and more lenders have entered the insurance distribution space, more agencies have left the banking business and turned to external financing (banks or other specialty lenders). Today, due to rising interest rates, agencies are considering returning to internal financing to create more flexibility and provide lower rates than outside banks and lenders. This creates an interesting tension between an agency and its next-generation stock purchasers.

- The agency may prefer to have employees buy stock directly from the company, with their purchases financed externally from a bank or other 3rd party lender. Although this is more costly to the borrowing employee, it creates a cash arbitrage for the agency since the agency can use the proceeds from stock purchases to reinvest in agency growth initiatives (e.g., hiring more producers, service staff and technology). It becomes an additional source of agency capital.

- The next-generation stock purchaser may strongly prefer financing provided either by the company or the selling-shareholder, since internal financing might come with an interest rate and terms more favorable than they could receive from a 3rd party lender.

In any case, regardless of the source of financing, agency leaders must solve the affordability equation if they hope to preserve independence for the next generation.

Over the past 12 months, many of our clients have been forced to dust off their shareholder and buy/sell agreements to address stock affordability. Below are a few strategies being used to combat the impact of rising interest rates.

Strategies to Improve Stock Affordability in a Rising Interest Rate Environment:

1. Focus on first-time stock purchasers. These purchasers are typically rising stars but given their stage of life have extremely limited capital. Agency leaders are getting increasingly creative at how to get shares in the hands of these first-time buyers. Once these rising stars get past their first stock purchase, things get easier – since they can use already-owned stock for subsequent down payments on additional purchases and/or can use profit distributions to help with funding.

2. Establish a defined stock purchase program. Agencies can leverage their scale to negotiate preferential rates and terms. Additionally, establishing a program removes ambiguity – the more employees know about the specifics of how and when they can buy stock, the more they can prepare to do so.

3. Offer interest-only payments for the initial 6-to-24-month period of the loan. Typically, this period is when a new purchaser is most strapped for cash, so they will be motivated to sell more insurance. Nothing motivates a producer to sell quite like a pending debt repayment!

4. Extend payback periods. We've seen certain agencies extend financing over 10 years (or even longer) to ease near-term cash flow pressure. Although shareholder financing terms that extend longer than an agency's own borrowing terms can hurt short-term agency cash flow, it likely will generate a long-term payoff as more employees will be able to afford stock.

5. Provide interest rate collars on existing and new stock purchases while always adapting and offering creative financing solutions given the ever-changing environment.

The path to internal perpetuation success requires flexibility and a thoughtful approach to an ever-changing valuation and interest rate environment. There is no single prescription for improving stock affordability, but agencies are encouraged to review existing programs and converse with new purchasers. A modest investment in preserving stock affordability can result in a big pay-off for an agency if it leads to enthusiastic buy-in from the next generation of high performers.

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