Rising Interest Rates

InsurBanc™
A Division of Connecticut Community Bank, N.A.*

Don’t Get Left Behind in a Rising Rate Environment

By David W. Tralka

Interest rates are rising again. In June, the Federal Reserve made its fourth upward adjustment in 18 months. The Fed’s recent tightening brings to a close a remarkable chapter in our monetary history. In December 2008, the prime rate fell to a near-record low of 3.25 percent and remained unchanged for seven straight years. Not since 1955 had rates been that low, and not for that long a period of time. As a consequence, many younger agency managers have never lived through a rising rate environment and may not fully appreciate the impact of higher rates on borrowing costs, cash management and agency values.

While most economists expect the Fed’s rate hikes to be gradual, it’s important to understand that because we have had low interest rates for so long, even relatively small increases will have a big impact on the cost of capi-tal. The historical average for the prime rate is 7 percent. As we move back towards that mean, borrowing costs will increase significantly — in fact, double. Agencies need to be prepared and take steps to better manage their capital needs.

Are you a user or provider of capital?

Remember the advice Polonius gave in *Hamlet* — “Neither a borrower nor a lender be”? It turns out those mous words from Shakespeare don’t apply to the agency world. Insurance agencies are always lending money (when they make deposits) or borrowing (to grow or perpetuate). So the first step is to recognize where you are in that continuum. Are you a provider of capital (lender) or a user of capital (borrower)?

If you're a provider of capital, you're making deposits and you have cash on hand. So you need to pay attention to how you manage that liquidity. That means understanding your cash management relationship — the fees, the return on your deposits, how much flexibility you have in moving money to capture yield. When money market rates are near zero (as they have been for the last nine years), deposits don't earn much. That lulls people into thinking that they don't need to actively manage their cash. However, when rates start moving back up towards 5 percent or more, they add real value to you and can be used as a tool to improve your bottom line.

Squeezing even incremental returns from your cash flow can pay handsomely. It's basically "free money" that goes right to your bottom line. Consider, too, the multiplier effect it has on agency value. Let's assume your agency has a value of six times its cash flow, and you're able to increase your cash yield by $5,000. You've actually increased the value of your agency by $30,000 (because of the multiplier). That's a pretty darn good return!

Why should I borrow?

Most agencies don't require regular borrowings like other businesses.. However, there are times when even forward looking should think about borrowing. Here are five good reasons why an agency might want to borrow:

- **Producer growth**. Agencies will often borrow to pay for the cost of bringing on a new producer rather than drain their working capital.
- **Investing in technology and infrastructure**. As agencies modernize to become more efficient and competitive, they may need to borrow to purchase new computer and office equipment.
- **Purchasing a building**. Owning versus leasing space may make sense for a growing agency. Borrowing makes that possible.
- **Agency perpetuation**. As agency principals approach retirement, they begin to consider ways to pass their firm on to the next generation — whether that's family members, their partners or an outside buyer. These types of succession plans generally involve borrowing.
- **Mergers and acquisitions**. Agencies looking to grow or enter new markets may choose to purchase a book of business or another agency. M&As and agency perpetuation are the biggest reasons for agencies to borrow.

Higher rates = higher capital costs

Trying to time interest-rate changes is a bit like trying to time the stock market, but one thing is certain: rates will continue to go up in the near term. With inflation under control and unemployment low, the Fed has been fairly transparent in signaling its desire to raise rates. So if you've been thinking about an acquisition, a buy-out, investing in new equipment or adding staff, now is the time to see your banker. The longer you wait, the greater the likelihood that your capital costs will be higher.

You can do the math yourself, but let's suppose you want to acquire an agency for $1 million. Over the last decade, the cost of borrowing has held steady at about 5 percent (prime plus 1–2 percent). So that would be $50,000 in annual interest expense. But if prime rises to 7 percent, you're now looking at perhaps 9 percent interest, or $90,000.

You can begin to see that interest rates really do make a difference. Paying more for capital means less goes to your bottom line, and that puts more pressure on earnings to make up the difference. You may decide that you can't afford to borrow as much as you'd hoped; maybe your acquisition or capital improvement gets scaled back or postponed.

That's not to say that you should rush into a deal. In the end, it's all about planning and making the right business decisions for your agency. But if you've had a proposal sitting on your desk for a while, you might want to consider moving it forward.

Agency valuations and perpetuation strategies

At some point every agency gets sold—a succession plan gets executed with an internal party or a third-party acquires the agency. Almost always there is a need to borrow funds. A son or daughter might use the value of the agency to take out a loan, or the owner might provide a seller's note to allow his managers to buy the firm. Or maybe a larger agency acquires a smaller firm with bank financing. Regardless of the vehicle used, the cost of financing will increase in a rising rate environment.

As rates rise, they can have an impact on agency valuations and the ability of buyers to acquire a new book of business or an agency. Keep these factors in mind as you consider your options:

- Agency valuations have increased over the last few years, and agencies today are generally selling at higher multiples than before. However, as interest rates rise, there may be fewer buyers willing to pay top dollar for your agency. Think about when mortgage rates go up. Homebuyers can't afford as big a house so they try to negotiate the price down or end up purchasing a smaller home.
- With rates climbing, a good strategy is to lock in a rate now with a fixed-rate loan. While these loans are initially priced a little higher than floating rate loans, they insure stability over the life of the loan and allow agencies to budget for the future. Over the long term, a sustainable loan is best for all parties involved — the bank and the borrower.

- Staged exits are one way for a principal to sell part of the agency now and the rest at a later time. You might consider selling 30 percent now and then selling the other 70 percent five years later. It's a good way to ease yourself out of the agency yet keep some control over the business. Also, if your agency grows in value, you can realize some of those gains by staging the sale.

Choose a bank that understands your business

You may not have any current borrowing needs, but that doesn't mean you won't someday. The key is to be ready, and that starts with building a relationship with a bank that can meet your needs for the long term. Does your bank understand the insurance business? Does it understand the unique requirements of your agency? Would it be able to help you if an opportunity came along that required immediate financing?

Are you using the value of your deposits to create a strong relationship that can pay dividends down the road? How well is your bank managing your cash? Is it suggesting ways to increase your yields?

A rising rate environment has its pluses and minuses. Rate hikes increase the price of capital, but they also mean higher returns on your money if you manage your cash well. Take the time to figure out whether you're a provider or user of capital, then work with your bank to create a strategy that's best for you.

David Tralka is the president and CEO of InsurBanc, a division of Connecticut Community Bank, N.A. As the CEO of InsurBanc, he is responsible for keeping the bank focused on being an innovative provider of financial products and services for the independent agency community. An expert on agency mergers and acquisitions, agency perpetuation and financing, he has presented at numerous venues nationwide.