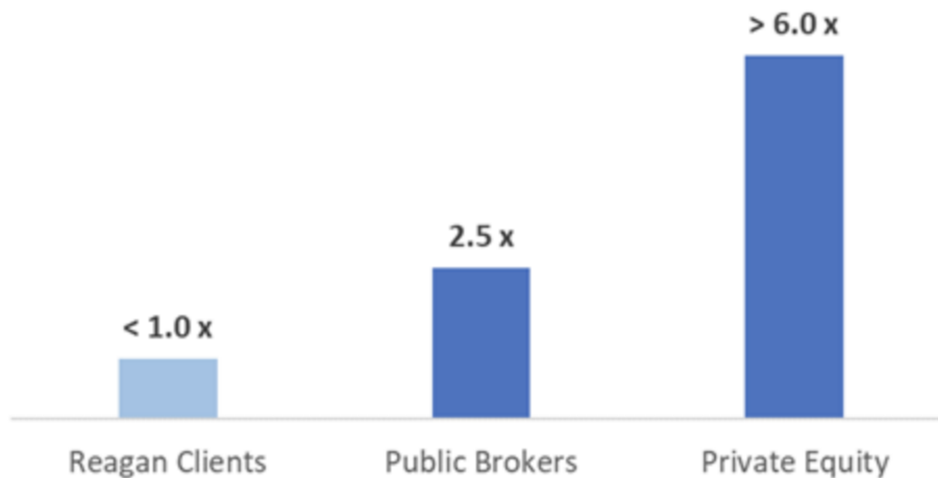
ReaganView

The Virtues of Debt

To our clients and friends,

Employee-owned agencies have significantly less debt than their publicly-traded and private equity-backed peers. Our typical client has outstanding debt totaling 1.0 x EBITDA or less, while private-equity backed brokers are often levered at 6.0 x EBITDA or more. Why are employee-owned brokers so under-levered? In today's low interest rate environment agencies have an opportunity to obtain cheap debt capital. Unaware of this, many agencies simply pass on investment opportunities or are tempted to raise outside capital.

Debt, however, is currently 4.5x cheaper than equity, assuming a typical agency equity return of 15% (combining share appreciation and distributions) versus the effective cost of debt capital of 3.3% (an assumed interest rate of 5.5% and a 40% tax rate shield). Alternatively stated, under this example interest rates would have to go up to a Jimmy Carter-era rate of 25% to approximate the cost of equity.



EBITDA is Earnings, Before, Interest, Taxes, Depreciation and Amortization. Reagan Client information is derived from the Reagan Value Index.*

Not only is debt capital cheaper, it is also more easily available to insurance brokers than ever before. We can thank the private equity industry for shining the capital market spotlight on insurance brokerage! Following private equity's lead, increasing numbers of lenders have gotten comfortable with the insurance distribution marketplace and are willing to lend money at very favorable terms.

The bottom line is that more agencies than ever before are exploring the use of outside debt as a way to fund events that are commonplace in an agency's life cycle: redeeming a large shareholder, financing new shareholder stock purchases, acquiring an agency, or buying an office building. When one of these trigger points comes, it may be wise to think strategically and ask the question: "Should we use this event to initiate conversations with capital partners to set up a strategic debt facility?" A strategic debt facility goes beyond financing an agency's initial need for capital and allows the firm to execute on strategic initiatives without worrying about future financing contingencies. We are frequently asked by our clients "What are the components of a strategic debt facility?" It depends on the agency's strategy. But for an agency considering an acquisition, we have outlined a few common components to be negotiated into a strategic debt facility:

- **Working Capital Line of Credit:** quick access to cash which can be used for small book of business purchases, strategic employee hires and technology investments
- **Refinance Existing Debt:** simplify the company's balance sheet and lock in low interest rates over a longer term (it's not uncommon to see 10-year financing in today's marketplace)
- **Acquisition Facility:** establish a pre-approved acquisition facility, with pre-negotiated parameters, which allows the firm to acquire agencies without the bank's one-off approval

allows buyers to finance their purchase over a comfortable period, while providing selling shareholders the cash they crave today

In certain rare instances, raising equity capital from outside of an agency makes a lot of sense. But for most agencies, debt capital is more prudent, especially in today's low interest rate environment.

However, in our historically debt-averse industry, questions abound:

- What is a prudent amount of debt for my agency to carry?
- Is now the right time for our agency to consider setting up a capital facility?
- Are personal guarantees really necessary?
- Do I have to give up my local banking relationship? What if my bank is a key client?

At Reagan, we've helped several clients answer these important questions and have advised them through the entire capital raise process. We add value in a variety of ways, including determining the amount of debt needed, modeling and testing to ensure the amount borrowed can be comfortably repaid, marketing our client to the growing lender marketplace and quarterbacking the legal negotiations prior to closing. The process takes approximately 60 to 90 days. Once complete, our clients are free to execute on their strategic plan without worrying about financing contingencies.

Your firm may be facing a trigger point. Is it time to set up a strategic debt facility?

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ReaganView is Reagan Consulting's forum for providing an occasional perspective onissues and opportunities relevant to the insurance distribution system

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