Interest Rates and Their Impact on Agency Valuations

The Start of the Leveraged Buyout Boom

Today's record-high insurance agency valuations got their start in 2007, just before the Great Recession. At that time, the publicly-traded insurance brokers[1] and large commercial banks[2] constituted the buyer groups who dictated the market for agency valuations.

At the end of 2007, HUB International and USI Insurance Services were taken private by Goldman Sachs Capital and Apax Partners in what amounted to historic leveraged buyout transactions. A leveraged buyout (LBO) is the acquisition of another company using a significant amount of borrowed capital to fund the transaction. This tactic drives up the acquiring companies' returns on the limited amount of capital that they did invest.

Up until that time, leveraged buyouts for insurance agencies were not common, as banks were hesitant to lend to an insurance agency due to their limited availability of tangible assets to offer up as collateral. The USI and HUB transactions changed all of that – not only did they prove that a stable and recurring cash flow base (such as renewable insurance commissions) could be borrowed against, they also proved that the leveraged buyout model could generate material returns for the private equity firm who sponsored the transaction.

The Impact of the Great Recession

Within a year of USI and HUB acquisitions, the world entered the Great Recession, which should have been alarming for the investor groups who took USI and HUB private. However, insurance premiums are not directly correlated with the overall economy, and HUB and USI proved to be stable cash flow streams and resilient investment platforms.

What the Great Recession did bring was historically low interest rates. In December 2007, the yield on the 10-year treasury was at 5%. By the summer of 2012, the yield had dropped to 1.5%.

[1] Major publicly-traded insurance at the time included HUB International, Arthur J. Gallagher & Co., Brown & Brown, and USI Insurance Services.
[2] Major commercial banks at the time included Wells Fargo, Bank of America, BB&T, and Wachovia.

10-Year Treasury Rate, 2000-2018

Source: https://www.macrotrends.net/2016/10-year-treasury-bond-rate-yield-chart

LBO debt comes in many forms but is typically a pooled loan from a syndicate of banks. The interest rate is floating and based on a premium to the 3-month LIBOR (London Interbank Offered Rate). The difference between the loan rate and the 3-month LIBOR is known as "the spread," and can range from 100-900 basis points depending on the credit risk of the company.

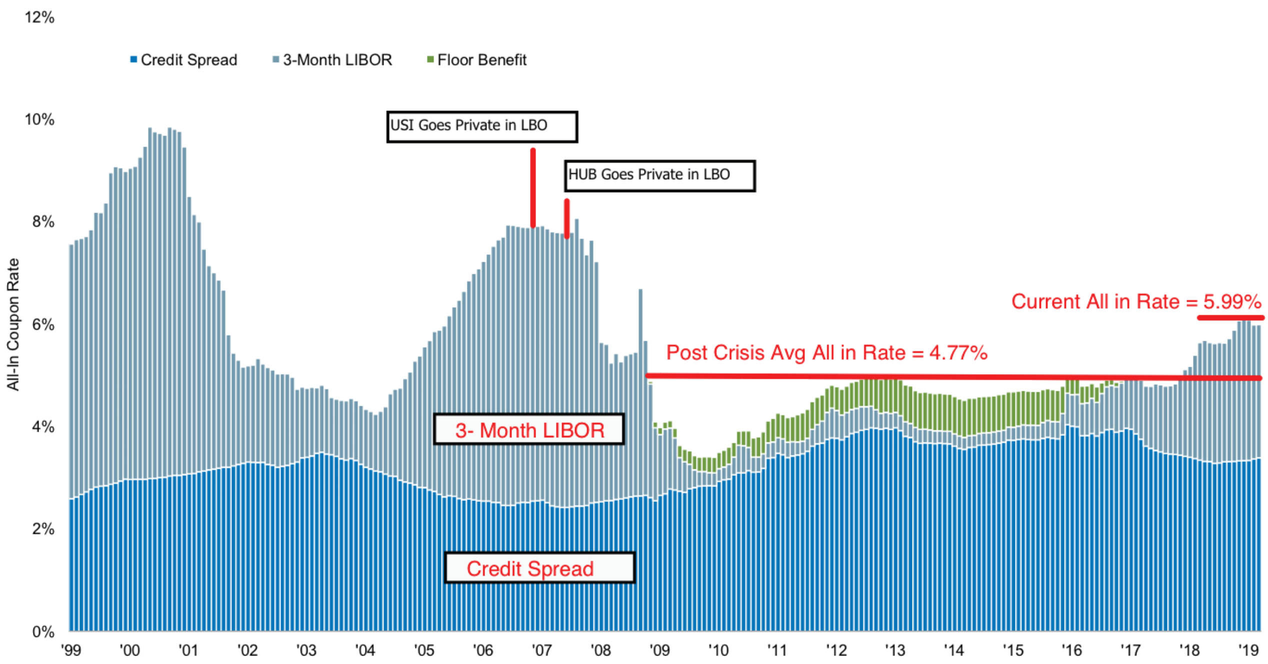
In the summer of 2007, the yield of "B" rated leverage loans was around 8.5%. By the summer of 2012, the "B" rated yield was around 5.0%. The 40% decrease in borrowing costs drove returns higher, and with it, more private equity firms began entering the space. This competition led to a roughly 20-30% increase in agency valuations over the same time period.

While the Great Recession may have led to lower growth prospects for most businesses, the reality is that property, casualty, and employee benefits rates are not directly correlated with the broader economy. As a result, this relative inelasticity limits the risk of an economic recession undermining insurance agency or brokerage cash flows.

The Impact of Rising Interest Rates on Agency Valuations

Today, there are over 25 major private equity backed brokers chasing a limited supply of agents and brokers to acquire, which has led to all-time valuation highs in the brokerage market. Each of the acquirers use a highly-leveraged capital structure to generate returns. Going forward, these returns will be driven down by the higher valuations now required to compete for an agency deal. The one variable that has remained consistent is the record-low borrowing costs – until now. In November 2018, the 10-year treasury more than doubled its 2012 low, yielding 3.3%, though this has dropped back down to 2.5% in the beginning of 2019.

Leveraged loan rates have begun to rise as well. Below is a chart from Eaton Vance that breaks out the historical components that drive the yield for the S&P LSTA Leveraged Loan Index, which tracks larger and more liquid loans. The yield has broken through its post-crisis average rate of 4.7% and now hovers around 6%, driving borrowing costs with it as well.



Sources: Eaton Vance, St. Louis Federal Reserve, and LCD, an offering of S&P Global Market Intelligence, 3/31/19.

Naturally, if you are buying agencies at today's all-time highs, with valuations and borrowing costs increasing by 30% as well, you should expect significantly lower rates of return going forward. This shift has yet to dampen agency valuations, but it is not a question of if they will be impacted – but when. Just as the high returns drew in all this new capital, lower returns should have the opposite effect.

About Sica | Fletcher

Sica | Fletcher is a strategic and financial advisory firm focused exclusively on the insurance industry. The firm was founded in 2014 by Michael Fletcher and Al Sica, two of the industry's leading dealmakers who have advised on over $6 billion in insurance agency and brokerage transactions since 2014. According to S&P Sica | Fletcher ranked as the #1 advisor to the insurance industry since 2017 in terms of total deals advised on.

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S&P Global
Market Intelligence

2018 LEAGUE TABLES FOR M&A
Leading Financial Advisors
Insurance

2018 Rank	2017 Rank	Firm	Number Of Deals	Total Reported Deal Value (*$ millions*)
1	1	Sica|Fletcher LLC	79	$730.0
2	2	Marsh Berry & Co. Inc.	74	$595.9
3	3	Mystic Capital Advisors Group LLC	37	$26.9
4	6	Optis Partners LLC	13	$1.2
4	4	Agency Brokerage Consultants	13	N/A
4	7	Dowling Hales	13	N/A
7	5	Reagan Consulting Inc.	12	N/A
8	10	Philo Smith & Co.	7	N/A
9	21	TAG Financial Institutions Group LLC	6	N/A
10	21	Merger & Acquisition Services, Inc.	5	$268.3

as of December 31, 2018

Source: S&P Global Market Intelligence