Third Quarter 2015 Allstate Agency Value Index Editorial

Being the creator and author of the Allstate Agency Value Index has afforded me the opportunity to write countless articles and to travel on behalf of PPCLOAN to speak to both Allstate Management and the Agency force. In the process, I have learned of the issues often faced at loan closing, such as the restrictive covenant.

So, this quarter I have asked Jeff Horner to share his expertise in the area of interest rates. He has written an insightful article with many points to ponder when borrowing for your Allstate business. If you would like to discuss current interest rates with Jeff he can be reached at jeff@ppcloan.com or toll free at 800-456-2779.

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Interest Rates… Friend or Foe?

The interest rate and the accompanying terms on your business loan can lead to a business's success, or if improperly structured, can lead to a business's demise. Utilizing debt, even at higher interest rates, can yield great wealth and substantial business gains. The rate of interest you are paying can be almost inconsequential, based on the quality of the investment opportunity at hand. However, when funds are borrowed to purchase assets at peak market value or when growth opportunity is limited, a good interest rate and the accompanying repayment terms can be vital. Let's talk about the role interest rates play in the Allstate insurance world:

1. PURCHASING POWER - Every Allstate agency purchaser looks at various factors, such as: What is the retention ratio? Is it a turnkey operation? Is the business profitable? How competitive is the product I am selling? Is the business growing or shrinking?

   One thing that is not at the forefront of agency purchasers' minds right now is interest rate and how it affects the ability to purchase. We have been living in an uber low rate environment for the past 7+ years and buyers haven't had to worry about interest rates. However, history clearly says this low rate environment cannot last forever.

   The Prime Rate of interest is currently sitting at 3.25%. Historically it is 6.75% in a good economy, meaning we are poised to realize at least a 3.5% increase in rates. Although the Prime rate in this example is used to price floating rate loans, we could experience an increase in fixed rate financing from somewhere around 6.0% up to 9.0%, or greater in the next 36 months.

   If you borrowed $1,000,000 today at 6.0% for 10-years, the payment would be $11,102 per month. Assume this is the ideal level of debt for the agency to service. An increase in the note rate from 6.0% to 9.0% would decrease your purchasing power from $1,000,000 to $875,000.

   At first glance it may appear that an agency purchaser must now come up with an additional

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$125,000 to close the gap in financing. In reality, the majority (if not all) of this pain will be felt by the Seller in the form of a lower purchase price.

Based on this analysis, one could estimate that 12.5% of agency values are inflated due to the low interest rate environment in which we currently operate.

2. CASH FLOW IMPACT - Anyone looking to leverage an Allstate agency certainly wants the very best rate. Loan terms can impact an agency's cash flow, with monthly debt service serving as one of the largest business expenses. From an Agency owner or purchaser's perspective, the type of interest rate (fixed, balloon, or adjustable) plays a large role in the cash flow of the business and excessive levels of debt can hinder business growth.

    - **FIXED INTEREST RATE** - A fixed-rate is when the interest is at a set rate that does not change throughout the life of the loan and the total monthly payment will remain the same. An ideal time to pursue a fixed-rate on a loan would be on a mortgage or extended business loan of ten years or more. For example, on a 30-year mortgage, a fixed interest rate is the most popular choice because regardless of how volatile rate movements become over time, your interest rate and monthly payment will not deviate.

    - **BALLOON RATES** - Balloon rates create different thinking when it comes to managing debt. A balloon-rate is typically a shorter loan around five years and resembles a fixed-rate. However, unlike a fixed-rate, the principal of a balloon-rate is not paid off at the end of its loan amortization. At the end of the term, the borrower must determine whether they will pay the remaining principal or take on another loan. A few benefits of this interest type are: 1) lower interest rates, 2) lower monthly payments, and 3) at the end of the loan life, the borrower is able to rethink their debt repayment plan. A drawback for a borrower with a balloon-rate might be forgoing the peace of mind that comes with knowing that the rate and payments will not change. If the interest rate environment did rise at the end of the term, they could potentially face some unaffordable rates.

    - **ADJUSTABLE RATE** - Another common interest rate is the adjustable or variable interest rate—when the rate of interest will vary over a period of time. The initial interest rate is fixed and set under the market rate, but after this fixed-rate period, the rate will adjust based on the market conditions. For example, adjustable interest rates are attractive for home buyers that plan to sell their home before the rate becomes adjusted, or for a borrower who plans to pay off their debt in a falling interest rate environment. However, if the interest rate market conditions increase, the borrower could see a significant rise in their monthly payment at an adjustment period.

Fixed-rates allow Allstate agency owners a simpler budget. For example, if a borrower has a fixed-rate on a ten year repayment term, they know that for the next 120 months the loan payment deducted from their

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commissions will not change. They don't have to worry about the potential rise of interest rates as they would with a balloon or adjustable-rate. The uncertainty of not knowing after a few years what their monthly loan payment will be is alleviated. It can be dangerous from a cash flow standpoint if monthly loan payments rise significantly, due to the affect it could have only other expenses the agency owner has, such as staff, office rent, marketing, etc.

The question then becomes, are Allstate agency owners with debt better off with a fixed and longer term repayment? Certainly, with rates at their historically low level and with increases on the horizon, the answer is yes. Floating rate loans at this point should only be pursued by those who have the capital to pay their debt load in full within the next 24-36 months (i.e. they are not rate sensitive). If your business focus is growth, lock in that low, fixed-interest rate loan, turn your attention to business management, and let your business interest rate be a friend not a foe.

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