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Dodging the capital gains bullet

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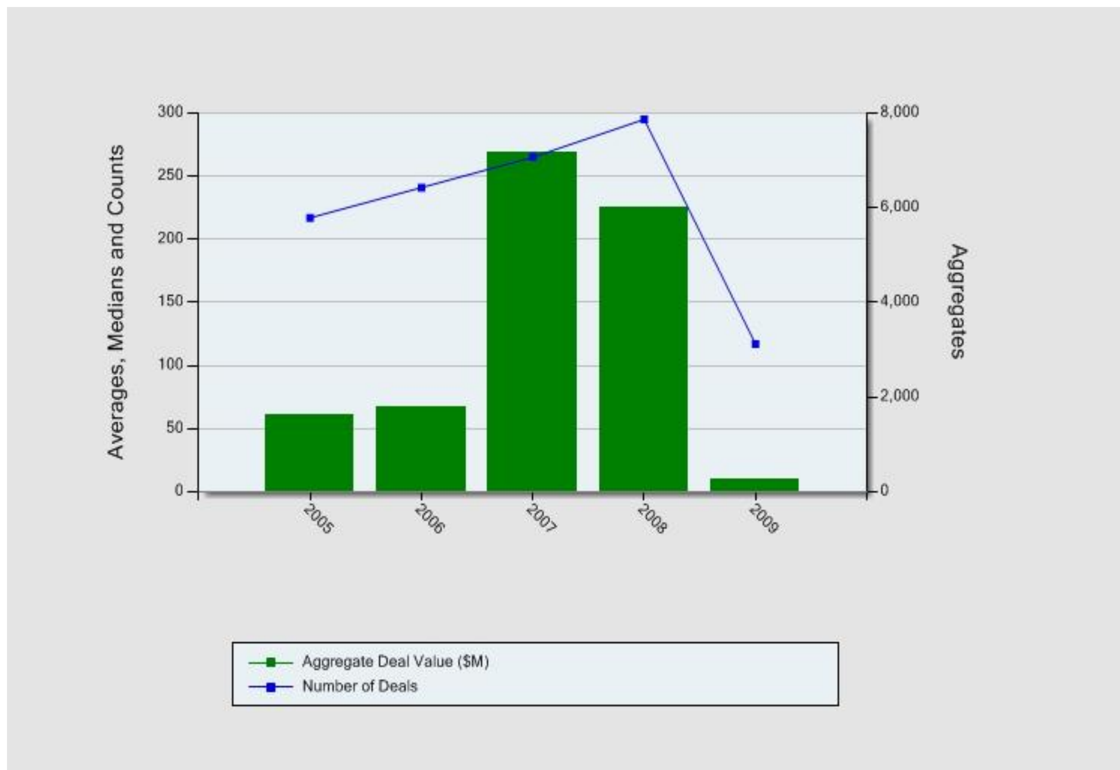
The current mergers and acquisition environment is very cloudy. Compared with previous years, 2009 has been very slow in terms of completed transactions. Most industry insiders expect the transaction environment to pick up over the next 12 months, but most seemed amazed it hasn't already started to happen.



Source: SNL Financial, 9/23/09

While the credit markets have played a major role in limiting transactions, that's just one of the reasons for the downturn. Others include: (1) price perception imbalance between buyers and sellers, (2) soft market concerns and (3) political uncertainty. But the one issue which has been discussed as a positive for getting deals done—the expected increase in capital gains— has yet to play a major role in driving deals. Why is that?

If you are an owner who has plans to sell your agency in the next 5 years, you should consider moving the sale date up to the next 12 months, as the expected change in the capital gains rate will have a material effect on your after-tax value. Any rate increase in capital gains, both federal and state, would have a multiplier effect on how much you would have to grow your agency to return to the after-tax

value. It is therefore vital that agency owners strongly consider these rate changes when they assess their near term strategic options.

To illustrate this point, let's pose the following: How much would you have to grow your agency to get back to the same after-tax value today if the federal capital gains rate increases 10 percent (from 15 percent to 25 percent)? We estimate you will have to grow your agency at least 14 percent. This is no small task, given the soft market and the intensely competitive marketplace.

Let's examine a simple comparison to drive home the point. Let's compare two sale scenarios: sell in 2010, or sell in 2011. The following table lists the assumptions

AGENCY REVENUE	$1 MILLION
Agency EBITDA Margin *	25%
EBITDA Valuation	6
Agency Valuation	$1,500,000
Payment At Closing	80%
Payment After First Year	10%
Payment After Second Year	10%
2010 Capital Gains Rate	15%
2011, 2012 & 2013 Capital Gains Rate	25%
Discount Rate	3%

* EBITDA = earnings before interest, taxes, depreciation & amortization

Pre-Tax Analysis

	SALE IN 2010	SALE IN 2011
Payment in 2010	1,200,000	-
Payment in 2011	150,000	1,200,000
Payment in 2012	150,000	150,000
Payment in 2013	-	150,000
Net Present Value	1,487,020	1,443,709

After-Tax Analysis

	SALE IN 2010	SALE IN 2011
Payment in 2010	1,020,000	-
Payment in 2011	112,500	900,000
Payment in 2012	112,500	112,500
Payment in 2013	-	112,500
Net Present Value	1,235,265	1,082,782

In this example, the owner would have to pay an additional $120,000 in taxes, or the equivalent of a high-end BMW or Mercedes. Wouldn't you prefer to have this money in your hands rather than the government's?

For those of you who are planning to sell within the next 5 years, it is time to put pen to paper and figure out when the best time to monetize your agency's value. Absent a huge belief that the pricing environment is going to harden fast, or your organic growth is going to skyrocket, strong consideration should be made to test the market over the next 12 months.

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