THE BELOW ARTICLE WAS PUBLISHED IN THE JUNE, 2010 ROUGH NOTES MAGAZINE

THE CASE FOR SELLING NOW

Change in tax rates provides a different set of numbers

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Everyone has heard the saying, “timing is everything”. Recently, when we have been talking to agency owners about whether the “timing is right” to sell their agency, we are often met with a lot of skepticism and hesitation.

Let me provide a few examples of conversations.

Agency Owner #1, a co-owner of a Southwestern U.S. based wholesaler: “We are down over 10% in net revenue because the market pricing is so soft. Standard markets are writing a lot of business they would have never considered a few years ago. Why would I sell now during a dip in the market? The timing just isn’t right.”

Agency Owner #2, a sole owner of a Northeastern U.S. based retail broker: “I hear sale multiples are down. Why would I do anything now? That would be like selling my house at the bottom.”

Agency Owner #3, a partner in a Northeastern U.S. retail employee benefits brokerage: “The economy has been so bad that a lot of our clients are laying off their staff, so even though we haven’t lost too many accounts, the number of lives in the accounts we have retained is down, and so is our revenue. And besides, my partner and I would collectively need $10 million to retire.”

All three of the owners above are in their 60’s, are expecting to retire within the next five years, and have a significant percentage of their personal wealth tied up in the value of their agency.

More importantly, all of these owners may be failing to recognize that a sale in 2010 may be **<u>the best</u>** opportunity for them to maximize the value of a sale of their agency.

Why? The current capital gains tax rates are historically low and agency owners may be facing an uphill battle if they do not consummate a sale in 2010.

To illustrate this point, assume the following: On a federal basis, capital gains rates are expected to increase from the current rate of 15% in 2010 to 20% in 2011. Capital gains rates vary on a state by state basis, but for this example, assume that they are currently 5% and will rise to 8% in 2011 and beyond (which may be conservative given the soaring deficits in many states).

How much would you have to grow your agency to get back to the same after-tax value today if the federal and state capital gains rates increases 8 percent overall (from 20 percent to 28 percent)? We estimate you will have to grow your agency bottom line **<u>at least 12 percent annually</u>**.

Let's look at a simple comparison to further illustrate this point. Consider two scenarios: sell in 2010, or sell in 2011. The following table lists the assumptions.

Agency Revenue	$3,000,000
Agency EBITDA Margin*	30%
EBITDA Valuation Multiple	6
Agency Valuation	$5,400,000
Payment at Closing	70%
Payment after 1st Year	15%
Payment after 2nd Year	15%
2010 Capital Gains Rate (Federal and State)	20%
2011, 2012, & 2013 Capital Gains Rate**	28%
Discount Rate	3%

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

**The tax rate used for 2013 does not include the 3.8% Medicare Payroll Tax that will be imposed beginning in 2013, which ultimately makes the net present value of a sale in 2010 vs. a sale in 2011 even greater than denoted below.

Pre-Tax Analysis

	SALE IN 2010	SALE IN 2011
Payment in 2010	$3,780,000	-
Payment in 2011	$810,000	$3,780,000
Payment in 2012	$810,000	$810,000
Payment in 2013	-	$810,000
Net Present Value	$5,329,910	$5,174,670

After-Tax Analysis

	SALE IN 2010	SALE IN 2011
Payment in 2010	$3,024,000	-
Payment in 2011	$583,200	$2,721,600
Payment in 2012	$583,200	$583,200
Payment in 2013	-	$583,200
Net Present Value	$4,139,936	$3,725,763

In this simple example, the agency owner would be over $414,000 worse off by waiting a year to sell their business. Keep in mind that this is a static example that assumes no growth. If revenues decline or margins contract the situation becomes even bleaker.

When discussing these numbers with the three agency owners I mentioned earlier, it becomes clear that all three are going to "bury their head in the sand" and hope the problem goes away. They say things like "We are going to wait until market pricing hardens before we sell the agency" or "We are just going to have to work harder to grow organically". The unfortunate reality is that no one knows when pricing will harden or if that will even translate into revenue and margin growth for these agencies.

While the changes in tax rates is a key factor in determining the correct time to sell an agency, the agency owner needs to not lose sight of other key issues as well.

One factor is the age of the selling owner. The three owners from earlier are all in their 60's and all run the risk waiting too long to sell. Most buyers want a commitment from a selling agency owner that he or she will is willing to work for a number of years after the transaction to both ensure the transition of the purchased business, and to help grow additional revenue. Transactions where a selling agency owner "hands over the keys and heads for the door" tend to have a significantly lower multiple, as they are viewed by a buyer as being riskier. Even if the intention of the selling owner is to continue with the business, buyers tend to apply a bigger discount, knowing that even with the best intentions, a selling owner is less likely to live up to these intentions.

Additionally, a selling agency owner should not ignore political and legislative risk. If state and federal governments continue to amass record deficits and are starving for tax revenue, there is a chance that tax rates go even higher! Even with the expected increases in 2011, top tax rates in the U.S. are nowhere near as high as they were from the 1940's through the 1970's.

Healthcare reform is another political issue. It is unclear how the recently passed legislation will affect health insurance brokers, but the simple uncertainty of the current environment has caused several of the larger national and regional brokers to be more cautious in acquiring employee benefits brokers until the picture becomes clearer.

The sale process for most transactions typically takes 6 to 8 months from inception to closing, so if you are thinking about selling in the next five years, you should seriously consider starting the sale process now in order to have the ability to complete a transaction in 2010. After testing the market, you may come to the realization that the timing really is not right for you to consummate a transaction, but you will never know this unless you have embarked on the process. By not doing anything, you are burying your head in the sand, and you are limiting your options in the future. Plan wisely!

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