Agency Acquisitions – Payment Terms

Authored by:

Joel Farley, President
Ron Christopher Co., Inc.

142 E. Main St.
New Albany, Ohio 43054

Ph: 614-398-2830
Email: jfarleyrcc@gmail.com

www.ronchristophercompany.com

Introduction

Whether you are buying or selling an independent insurance agency, the payment terms of the sale are going to be very important. The actual selling price is of highest importance, however, how and when a seller gets paid is of equal interest. Each side should discuss payment terms early in the negotiations and not let the discussion on the subject come at the end right before closing. If you do wait, you might nix the overall transaction.

In this short, this whitepaper will discuss various aspects of payment terms. The material discussed is for informational purposes and each buyer and seller of an agency needs to make their own decision. In other words, you are the ultimate decision maker.

Pricing Structures

More often than not, the equity of an insurance agency is the largest single asset for the agency owner. The owner has worked most of his life building his agency and is seeking to get a back-end reward for that work. The money from the transaction may be very important if the owner has little other assets to support his retirement. In other situations, the proceeds from the sale may be one of many assets for a successful businessman. All in all, most sellers are not interested in getting paid on a variable structure, thus, they seek a sale based on fixed pricing.

From the seller's point of view, the management and success of the agency post-sale really depends on the management skills, drive, business savvy and perseverance of the new owner(s). The relevance here is risk vs. reward as well as the buyer's mitigation of risk by using a variable pricing arrangement. From the buyer's side of the table, they are buying an asset that may continue to succeed or could fall on hard times. No one can predict the future.

The economy may have good times and bad times. Insurance carriers can be added to the agency and insurance carriers can cancel agency contracts. Key employees can come and go. New customers will be gained but customers will be lost. Large commercial accounts can be lost that significantly affect the bottom line for the agency. Lawsuits can be brought against the agency for known liabilities as for those that are unknown. All in all, as with all businesses (including insurance agencies) there is risk which could be substantial.

A main goal of the buyer is to minimize their risk in the transaction mainly through financial and carrier due diligence but also through variable pricing structures. Let's explore two types of variable pricing structures.

<u>Commissions Renewals</u> - The usual approach by buyers in variable pricing arrangements is to base the pricing off of commissions that renew in the future. Typically, the buyer will put down a small down payment (say 10% of the final estimated selling price) and then pay the seller over 3, 5 or 10 years for the remaining portion of the transaction. The buyer figures that the seller should only be paid for what renews as this keeps the seller "honest" as many sellers misrepresent what is being sold.

Sellers are very hesitant with getting paid on renewals as they have no control over how the agency is run after the sale. For all they know, the new owner(s) could be widely successful or run the agency into the proverbial ground. As an absurd example, you wouldn't sell your house based on how the new owner felt about the aesthetics and the function of the house over time. One day the owner might really like the neighborhood only to change his/her mind later. There may be unexpected repairs with hot water heaters, HVAC systems and plumbing that comes up which is not the fault of the previous owner.

Houses are sold on a fixed pricing in almost all circumstances, thus, it's not unreasonable for sellers of insurance agencies to ask for the same thing.

<u>Future Profits</u> – The other variable pricing structure is to get paid on how the agency performs in regards to future profits. This is even more risky to the seller than getting paid on commission renewals. Commission renewals are fairly straight forward in terms reporting. Each carrier provides a carrier report to the new owner which can be passed onto the past owner. In other words, it's hard for the new owner to "fudge" things about renewal commissions.

As for the profit method, there's all sorts of ways the new owner(s) can cheat-out or minimize payments to the past owner. It's the devil in the details. As in all businesses, it comes down to revenue in relation to expenses. The wider the difference between the two produces better profits. For the seller, he shouldn't be worried much about the revenue as that can be confirmed via carrier, reports, financials statement and other documents like bank deposits.

When it comes to expenses, expenses can be highly manipulated to minimize profits. Small business owners are notorious for exaggerating expenses to cut down their tax bill to Uncle Sam. Owners will expense non-business items like:

- Personal car use
- Vacation homes
- Personal expenses of close family members
- Vacations that don't relate to business
- Golf and club-type memberships
- Mortgage payments on their personal residence
- Furniture for his or her house
- Spa treatments
- Traffic tickets
- Boats

The types and variations of non-business expenses are only limited by the imagination of the agency owner. It's not recommended to base your selling price on future profits.

For the majority of insurance agency sellers, the pricing of the agency is fixed and not based on a variable basis. Having said that, buyers will offer significantly higher pricing for the business if it is fully or partially based on variable pricing. You could see a 30%-40% higher amount for your business with a variable structure. It all comes down to how much risk you can tolerate vs. the reward for that risk.

Payment Terms

Assuming the buyer and seller have agreed upon a fixed selling amount, the next subject is how and when the buyer will get paid. On one extreme, the seller will say that he wants 100% cash at closing or he won't sell at all. Many buyers will avoid this situation as they feel that there's no recourse against the seller if the seller has materially misrepresented her business. They may also feel that the seller has something negative about her business to hide.

As for the buyer, the extreme example is putting $1 down and then make payments over a period of time (up to 10 years). Again, the majority of sellers will not have interest in this situation for many reasons:

- The seller needs money today to pay off debts, pay bills or take care of an elderly family member.
- The seller feels that the buyer will not pay them back and will have sold their business for naught. This may even be true even if buyer pledges unencumbered assets as collateral in case the buyer doesn't pay.
- The seller is older and he thinks he won't be around in 5-10 years due to health conditions.

- The seller thinks that the buyer is short on cash and may or may not have the financial stability to run his current business and the seller's business if there is a downturn in the economy or local market.

All in all, both extremes only make sense for a few buyers and sellers. It's kind of like a bell curve where the majority of buyers and sellers are huddled together in the middle of the curve. If you are working with an M&A firm that's been around the block a few times, they will usually weed-out buyers and sellers who are at the two extremes.

Having said all of this, a good amount of sellers will want anywhere between a minimum of 50% at closing to a top end around 90%.

Tax Implications

Paying Uncle Sam is true in our personal lives as well as our business lives. Thus, it's important to see how taxes may affect your decision on payment terms. In most instances, the seller is concerned about capital gains taxes paid on the federal level. A capital gain is basically the difference of the cost paid for an asset vs. what it sold for. Thus, if you pay $15 for a stock 5 years ago and you sell it today for $25 today, you have a capital gain of $10.

Since most insurance agencies have been held by the buyer for at least a year, you will be facing the more favorable long-term capital gains tax rates. In 2017, there are three tax brackets of 0%, 15% and 20%. Unless you are very poor or are making over approximately $450,000 per year in total income, your long-term capital gains rate will be 15%. Thus, in our example above, the seller will pay $1.50 for each $10 of capital gains she has.

So the question is: "How does this tie-in with payment terms?" In general, it's desirable to pay taxes later than sooner. One way to do this is to take payments for your business over a period of years instead taking it all at once. If you get paid 100% cash at closing, you'll pay 100% of your capital gains taxes to the Feds in that tax year. However, if you take all or some of the selling price in payments over a few years or more, then you're capital gains can be deferred.

For those sellers who are risk averse and don't want to take payments over 3-10 years, there's a strategy to get your money almost immediately but defer part of your taxes for up to 16 months. For example, let's assume that your business sells for $500,000 and your capital gain is going to be $400,000 in total. If you take the full amount at once you are going to owe $60,000 in taxes in the tax year of when the monies where received. Not fun!

The better path is to take part of your money on December 31st of one year and then the rest of it on January 1st of the second year. More specifically, the money received on December 31st will incur a capital gain that is not due until April 15th of the following year. As for the money received on January 1st of the second year, the taxes will not be due until April 15th of the third year. Thus, using our $500,000 example above, things would come out like this:

- $250,000 received on 12-31-17 (or earlier in the year), the tax owed ($30,000) will be paid no later than 4-15-18 of the following year. That's a 4+ month time period before you have to pay up.
- $250,000 received on 1-1-18, the remaining $30,000 in taxes will be paid at the latest on or before 4-15-19. That's a full 16.5 months later!

Altogether there are many factors to consider when negotiating payment terms and if you have further questions please contact:

Joel Farley, President
Ron Christopher Co., Inc.

142 E. Main St.
New Albany, Ohio 43054

Ph: 614-398-2830
Email: jfarleyrcc@gmail.com

www.ronchristophercompany.com