TobinLeff
M&A Advisors
WHITE PAPER

Did I Miss Out, Should I Have Sold a Year Ago?

By Chuck Gottschalk

Many people are asking this question today—"Did I miss the window, should I have sold a year ago?" But before we can answer that question, we should clarify, sold what? Should you have sold stock you own? Perhaps you are asking about your home? Oh, that's right, you are reading an article from an M&A advisory firm, so you are asking if you should have sold your company.

Well, before we get to the answer about your company, let's talk about the first two, starting with your stock sale, and let's assume it's Chevron. Assume that you bought your stock in Chevron on January 1, 2022, for $131.33 a share. Next, assume you thought that you should have sold it on October 17, 2022, when it was $173.19 a share, because as of October 9, 2023, it's sitting at $164.06, down 5.6% from a year ago. And yes, these are all actual prices on these dates. So, had you sold the stock on October 17, 2022, you would have realized a short-term capital gain of $41.86 and paid around 35% in taxes, leaving you with a net profit of $27.21. Now had you sold on October 9, 2023, you would have realized a long-term capital gain of $32.73 and paid 20% in taxes, leaving you with $26.18. The math here says it really doesn't matter much if you sold now or a year ago. But this is just one stock, and if you used the same dates with Tesla, you would find you should have held, and if it were Disney, you should have sold. So, the answer is, it depends.

Now as to your selling your house. The question is, "Why are you selling your house and where will you live?" If you live in the Northeast and want to move to Florida, you will find that home prices in Florida have dropped more than in the Northeast over the past year. As such, you would find that it was a good idea to wait. Now if you have a mortgage and will take out a new mortgage, you will find that it was likely a bad idea to wait, as mortgage rates have gone up significantly, making your payments for the same amount borrowed rise significantly. So, the answer is, it depends.

So, you are probably thinking that when it comes to selling your company, we are going to conclude, it depends. But that, in fact, is not where we are headed; we believe that selling your firm a year ago versus today is much more like selling Chevron stock, and it doesn't matter much. So why is that?

First, there is a misconception in the marketplace that rising interest rates are driving down prices for agencies and services firms in a material way. That has not been our experience at TobinLeff. The reason for this is that although borrowing rates have increased significantly, the impact of this on a deal is not that material. Assuming that a buyer borrows 25% of the purchase price (service firms are not like houses; most of the purchase price is not in the form of debt), the rise in interest rates over the past year from 8% to 13% has only driven down the after-tax returns after 5 years by about 3%. Yes, it's down, but not a needle mover.

Next you might be thinking, "Ok, so the interest rate doesn't matter much, but my earnings are down and therefore it must be worth less?" If your earnings are down, you are not alone, but how might that impact your net worth if you sold in 2022 as compared to 2023 or 2024?

When agencies and service firms are sold, the most common formula structure used is cash at closing and then potential subsequent payments through an earnout formula that are almost always capped. The upfront payment and target purchase price (achieved through the earnout payments) are established based on the seller's earnings at the time of closing. However, ultimately the buyer will pay the seller a multiple of the earnings that they realized while owning the acquired company. So, what does this mean for your decision not to sell a year ago?

Let's assume that in 2022 you made $1.0 million, and you agreed to terms with a buyer that would pay you 5x of your 2023, 2024, and 2025 average EBITDA with a ceiling of $6.5 million. The cash paid at closing is $2,000,000 ($1 million in earnings at closing x 5 x 40%.) At the time of closing, it was estimated that your earnings would be $1.1, $1.2, and $1.3 million in 2023, 2024, and 2025, respectively. This would have got you to a $1.2 million average EBITDA x 5, and, ultimately, you would have received $6 million. But now your earnings are down in 2023 to $0.9 million, and you are expecting a recovery in 2024 to $1.0 million and in 2025 to $1.1 million, which will bring you back to an average of $1.0 million for the five years; so, ultimately, you get $5.0 million.

Now because you have waited, your actual earnings at the time of close on 12/31/23 are $0.9 million, and the target price is now $4.5 million, the 40% payment at closing is $1.8 million, and a ceiling of $5.85 million (again, 30% above the target). Your actual earnings in 2024 and 2025 are $1.0 million and $1.1 million, and let's assume that 2026 brings $1.2 million. Your average is $1.1 million, and the ultimate purchase price will be $5.5 million (5 x $1.1 average). Now in this case, you are ahead of what you would have received had you sold on 12/31/22. There is also the fact that you would get to keep the 2023 earnings, so one could suggest that you are $1.4 million ahead.

The reason for being ahead by selling in 2023 is ultimately that your total sales proceeds are determined by your actual performance during the earnout period. Furthermore, the longer you hold will likely result in more money for you. You may have thought that selling on 12/31/22 would have been materially better, but nearly all buyers have some sort of safeguard against underperformance post-closing that mitigates this risk. And having a bad year immediately after the closing comes with risk to a seller that buyers have transferred. A bad year in the third year doesn't tend to have nearly the same impact. So perhaps by waiting, you dodged a bullet?

It has been long said that you shouldn't try to "time the market." The example often given is that if you had invested in the stock market the day before the 1987 crash, then two years later your investment would have been worth more. It would not have been a fun ride, but the point being is that things recover. The time to sell is when it's right for you to sell, and this is different for every owner.

You will know when the time is right to sell. Perhaps you have reached an age when you want to retire, maybe you decided to take some "chips off the table," or perhaps it's time to go off to your next calling. Those and plenty more are good reasons to sell.

At TobinLeff, we are optimistic about opportunities for clients who feel 2024 is the right time to sell. Financial buyers (private equity groups, family offices, and venture capital firms) have entered the MarComm space in a big way, and they have plenty of "dry powder" to invest in quality companies as platform or add-on investments. Likewise, many consulting firms' and other agencies' growth plans include acquisitions, and there is no shortage of potential buyers for quality companies with a story to tell. Instead of trying to time the market, tell your story when the time is right for you.

About TobinLeff, LLC

TobinLeff is a leading M&A advisory and exit planning consulting firm, helping owners sell to strategic buyers and private equity groups. With 13 years of service, TobinLeff's team of senior advisors brings a wealth of Mergers & Acquisitions experience as former business owners, accountants, attorneys, and bankers dedicated to the mission of helping their clients maximize and monetize their life's work. TobinLeff is the go-to resource for business owners looking for true partners in their exit planning journey.

Contact:
Chuck Gottschalk
cgottschalk@tobinleff.com
412-607-1838