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VALUATION OF A LAW FIRM – MUCH MORE THAN MATH

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This article is a preview of the seminar on "Valuing and Selling Your Law Firm" which the authors will be presenting at the upcoming PBA Solo & Small Firm Section Conference. Our session is scheduled for Thursday 7/29/21. We encourage you to attend this virtual conference. It is jam-packed with great sessions spread over a few hours on successive days. Section members receive a substantial discount, and PBI ProPass subscribers can register for free.

We are each frequently approached by attorneys who want to validate the "guidance" they've received elsewhere about valuing their law firm. Sources of information and advice include online articles, publications, CPAs, business brokers, consultants, and colleagues who have successfully sold their own practices. Viewpoints abound.

Most advice involves a preconceived easy-to-calculate formula or methodology. These "rules of thumb" make valuing your practice sound simple and easy, but as with so many things, short cuts don't always lead to good answers.

Most callers are disappointed when told that although math and data are a necessity, they don't alone allow one to calculate value. There are lots of subjective criteria that impact ultimate valuation. Because what a buyer is really interested in is value which will be transferable, e.g. realized, by the acquirer.

Let's explore the factors that feed into determining value.

Situation – All value must be determined based on the situation(s) involved. For example, is the practice being acquired by a larger firm? If so the value of goodwill must bring more to the table than just additional revenue. Ultimately the projected impact on profits per partner will come into play.

Are your current equity partners going to affect this number — positively or negatively? If you have overpaid, underutilized equity partners, it will negatively impact value. Similarly, if your firm attorneys require a much higher ratio of staff to attorneys to get the work out the door than the acquiring firm, it will negatively impact value.

What additional subjective value-added synergy might your firm offer? Additional practice areas for their existing client base? Good. A better competitive advantage? Great. Ability to leverage quickly on acquired intellectual capital and people talent? Excellent.

Is your firm being sold to carefully developed in-house successors? If you have worked hard to transition relationships, your value may be equal to or greater than the profit margin on revenues produced by your clients. However, a common mistake is to include in the sale price the revenues being generated consistently by the future buyers' clients. Remember, that is conceivably portable business. Why would they want to pay you for their own book of business? You just might be tempting them to set up their own firm, taking that business with them. It doesn't matter if they were only able to develop the book because you gave them the opportunity. Loyalty usually doesn't figure into the sale value of the firm.

Identification of revenue streams – The more the seller is able to identify and quantify sources of current revenue, the more likely that it will predict selling value. For example, knowing and demonstrating that 50% of average revenues originates from marketing initiatives, such as a Google AdWords social media campaign, the more reassured the buyer will be that the revenues will continue to flow in the door by maintaining the marketing strategy(s) employed.

Is a large portion of your work coming from former clients or a number of identifiable well-cultivated referral sources? This work often quickly evaporates following a sale. It takes a solid transition plan to convince a potential buyer that this type of work has value. And it will likely affect payment terms as well. The buyer will want to wait and see whether any of these revenues actually transition, before agreeing to their value.

Profit margin / efficiency – for every dollar of revenue collected by your firm in a year, how much goes to pay overhead that does **not** include owner compensation and benefits? No matter what your firm's entity – PC, LLC, PLLC – owners may call their compensation salary, draw or something else, but the reality is that equity owners earn what is left over after the business expenses are paid. What's available to owners is often identified as "seller discretionary earnings." The larger the profit margin, the better the operational efficiency, and the higher the value.

In today's marketplace, a firm which generates a profit margin of between 45¢ - 55¢ on each dollar of revenue is in the sweet zone. If your practice is being sold to the next generation, the question the buyers must ask themselves is whether they believe that they can continue to run the practice at least as efficiently, or more so, than you did.

If your practice is being acquired by a comparably sized practice with a lower profit margin, the buyer should be willing to pay a bit more if they can put your efficiency to work for them. However, if the buyer is larger and less efficient, they will discount for your additional profits, because under their management, your enhanced profit margin will never be realized.

Practice areas -- A practice area desirable by one firm as complementary, may be a deterrent to another because it creates conflicts or provides no cross-marketing opportunity.

Some practice areas are 80% or more commodity work, which requires a careful watch on rate increases, matter management, and legal spend control for clients. By the same token, these practice areas typically provide consistent cash flow, and good work for training associates. The firm will be most highly valued by a buyer that has under-utilized attorneys, and/or huge swings in cash flow month to month.

Other practice areas command premium rates because they require in-depth knowledge to produce unique high-value results. These practices, generally, have a higher sale value.

Some practice areas are built upon institutionalized clients. Typically, the more practice areas you can provide for that client, the wider variety of work you will get. When a firm services a broader array of a client's legal needs, it ties the client more closely to the firm and reduces the risk that the firm will lose the client. Multiple relationships usually service these clients from a retention standpoint. On the other hand, strongly relationship-driven clients tend to be good referral sources and consistently return to "their" lawyer. Unfortunately, these kinds of clients may be inherently less transferable without a comprehensive transition plan.

Remember, transferability increases value. Unique high-value work increases value as long as the talent to provide the service exists at the acquiring firm, or comes as part of the sale. (Yes, nothing is guaranteed.)

Other considerations that figure into value (much of which will be covered in the seminar but not this article)

- The "value equation;"
- Why "rules of thumb" mean little;

- Data, data, data – knowledge of your practice's underlying financial and operational data is critical to maximizing value in a sale; and

- The "deal" that worked for the firm down the street won't, necessarily, work for yours, leaving both buyer and seller dissatisfied.

When you call upon an "expert" to help you determine the value of your firm, and their response is something like,

> *"Ok, you do PI work, which is high value work. That's worth annual average revenues for the past 5 years, times a factor of 4."*

know that it is not that simple, and you cannot rely upon that for more than daydreaming about how you might spend your money in retirement. You should expect to hear a range, depending on different scenarios. And you should be advised of the strategies to maximize value, or more easily demonstrate it to a potential buyer.

Michael Molder, JD, CPA, CFE, CVA/MAFF is the owner of AILA Limited, where he applies over 35-years of experience as a public accountant and commercial litigator to help attorneys help their clients with a wide variety matter including commercial litigation, matrimonial disputes, fraud investigations and valuations of privately-owned businesses. Feel free to contact Michael at 610-206-3169 or via email at molder@LawAndAccounting.com

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