Valuing Professional Service Firms

By Christof Binder

Professional firms are frequently engaged as advisors in selling and acquiring businesses on be-half of their clients, as well as determining the value related to such acquisitions. When it comes to their own firms, however, many CPAs have no precise conception of value and price.

Mergers in the professional services sector remain a common strategy for firms looking to boost revenue and acquire new clients, as well as for professionals seeking to retire. Because most are private companies, and generally do not have external equity investments, the financial terms of takeovers are rarely disclosed. Therefore, the objective is to understand more about valua-tion multiples, and about the levers driving valuation.

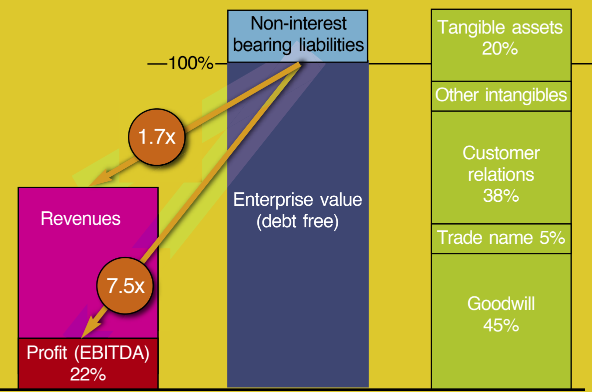
A sample of takeovers of such firms by public companies that were subsequently reported in the financial statements of the acquirers (purchase price allocations), taken from the Markables database, provides the basis for a deeper analysis. Beyond the purchase considerations paid, the structure of the acquired assets was analyzed. The sample covers 18 acquisitions of account-ing and law firms between 2006 and 2016 in the United States, United Kingdom, and Australia. The targets ranged from $7 million to $129 million in revenues. The sample is represented graphically in the *Exhibit.*

Earnings multiples typically range from 6× to 8× earnings before interest, taxes, depreciation, and amortization (EBITDA), or 11× to 14× net income after tax. These are rather moderate mul-tiples, reflecting the limited scalability and growth potential of people-based services, where capacity is always a limiting factor. Sales multiples typically range from 1.3× to 2.2× revenues, depending upon profitability. Professional service businesses are highly profitable; typical profit margins range from 15% to 30% on revenues (EBITDA).

Accounting firms are primarily acquired for the value of their existing customers; customer rela-tions accounts for 38% of enterprise value on average. Customer value is influenced by the stability of customer relations (repeat business like IP lawyers and auditors, or project business like litigation or corporate finance advisory), excess margin (higher on projects, lower on ongoing repeat business), and the independence of customer relations from key individuals. Over the total sample, the customer asset has a relatively short remaining life of 10 years. Eventually, customer value must be secured through noncompete or employee stock ownership plans (ESOP) to prevent key individuals from leaving and taking customers.

The trade name of the firm is of minor overall importance; however, its reputational value has an important role, replenishing short-lived customer relations in project-based businesses. The reputational value of the trade name helps not only to create future customer relations, but also to attract new talent to the firm. Still, the trade name only accounts for an average of 4% of enterprise value. Depending on the background of the transaction (i.e., new territory or consoli-dation), the trade name of the acquired firm is assumed to be kept and maintained in 8 of the 18 cases. In 10 cases, the acquirer plans to replace the trade name of the target with its own name over time, on average within four years of the takeover. This translates into an implied royalty rate for the trade name of 1.5% on revenues under a royalty relief valuation.

Exhibit
Value multiples in professional service firms
- 18 reported takeovers of accounting and law firms



Source MARKABLES

Other intangible assets, typically including software and non-compete agreements, are insignifi-cant at less than 1% of enterprise value. Tangible assets, meanwhile, account for 20% of enter-prise value; they consist largely of liquid financial assets and receivables but also include a smaller amount of fixed assets like office equipment and company cars. Typically, such busi-nesses are fully self-financed. Therefore, tangible assets (book value) are financed free of debt and do not increase enterprise value.

One important asset remains: goodwill, which makes up 45% of enterprise value. This should, however, not be taken as a pure residual; it includes a number of seizable components. One is the cost savings expected from the combination, while another, more important component is the cross-selling potential in combining different territories, customer groups, or service ranges. Finally, goodwill includes the ability of the acquired firm to create enough new business to keep the firm running at its current profit level beyond the current planning horizon. For professional services firms, retaining key individuals is vital for this. A high price for a professional service firm must therefore include clear measures to retain key staff. For those who plan to sell an accounting firm, it is important to focus on those assets that are important to acquirers and drive the value of the business ❑

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