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Are Law Firms Valuable Businesses?

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Well managed, profitable, organised businesses with repeat customers are worth real money. Why not law firms? We now have a large, successful, publicly owned law firm with a rising share price. It is not uncommon for small, successful firms to be purchased and sold. Many firms have retained goodwill in their balance sheet, sell interests to incoming partners and buy them from retiring or departing partners. So what are firms worth?

If any business is to be valuable it must be profitable, organised, able to achieve replicable results through quality systems, and have some degree of inimitability. In many respects, law firms are not that different. There are however some aspects of law firms that make the valuation process unique.

We are regularly involved in the valuation of law firms. We see and often are asked to comment on an accountant's valuation. Seldom ever is the same methodology used. If one asked ten accountants for a valuation, it is a safe bet that one would get ten different methodologies and ten different prices, all paying scant regard to the critical aspects of valuation. The only commonality in method or result is the disclaimer page.

Any rigorous valuation should take into close consideration seven essential elements.

Profitability of the practice

The greater the return on investment, the greater the value of any asset, relative to risk. Potential purchasers will pay a premium for a practice that delivers high returns.

Any business should return a salary to all working owners. Astute purchasers will not buy a salary; you can get one for nothing. Saleable profit is the amount of income generated after salaries and expenses, including reasonable market salaries for all working partners. In a partnership structure these may be "notional salaries". Such salaries should reflect the marketplace for like lawyers.

Value will be greater where there is a history of consistent profits. Value will be greater if profits are generated by the operations of the firm as a whole rather than any one individual. These circumstances minimize risk for any purchaser.

Consider two firms that return the same profits to the principals. One is a high-end litigation practice with a heavy reliance on a senior partner for client development and fee generation. The second is a property practice with a number of developer clients that are serviced by a team of lawyers and paralegals. All other things being equal, in our experience the property practice would attract a higher valuation.

Free cash flow

A constant challenge for firms is improving the speed with which activity, or work in progress, becomes cash. When it comes to valuing a practice, a commercially astute purchaser will want to examine how quickly a firm converts work-in-progress into debtors, and debtors into cash.

A rigorous valuation will include a free cash flow factor in determining the profit multiplier applied. When considering goodwill, firms with low levels of WIP and debtors will be valued greater than firms carrying large amounts of inventory. Note: WIP and debtors are usually valued separately from the goodwill, so large amounts of WIP and debtors (if sold) would have the capacity to increase overall sale price.

Investment payback period

The investment payback term (IPT) is the maximum period a purchaser would accept to receive a total return of funds invested. It is, in part, an assessment of the risk involved in purchasing the firm.

In many respects this is a balancing act. The payback term should not be too short or too long. A practice that is subject to significant risk may be profitable with desirable cash flow but the inherent risk will give rise to a shorter IPT (say one year). A less risky business may have a payback term of three, five or more years. Although contradictory on face value, the logic is that the lesser the risk associated with a practice the greater the likelihood of any purchaser adopting a longer-term view and the greater the valuation, regardless of profit levels. This is of particular importance for external sales.

Considerations when determining investment payback term include:

- Brand awareness
- Recurrent nature of client base
- Level of reliance on current principals for fees and clients
- Areas of law practiced
- Competition

Client concentration

The personal nature of the law means that clients often identify more with a lawyer than a firm. Branding and promotion of individual partners and employed lawyers has distinct marketing advantages but it devalues a practice relative to a circumstance where work is attracted by the brand of the firm and evenly distributed.

Law firms with a strong delegation culture and good leverage usually attract a greater value. Conversely, if a rainmaker who takes pride in personally serving his clients is selling his share of equity and won't be involved in the practice beyond sale, one could reasonably expect a lesser value

Recent investment in operations

Occasionally we see some creative approaches to profit maximisation. Profit in any period can easily be maximised on a profit and loss account by deferring necessary upgrades and investments, particularly in IT and office fit out. Purchasers should be wary of aging IT platforms, as the likelihood of a major and costly upgrade could be around the corner. Similarly, beware that scheduled office fit outs or improvements haven't been deferred to take place immediately after sale. Well run, organized businesses will amortise necessary assets over their workable life. This demonstrates a stable business and reflects in value.

A review of the depreciation schedules usually indicates the investment program. Similarly any valuation should consider a comparative review (using comparative financial benchmarks) of lease expenses for computers, software and any deprecation amount appearing in three consecutive profit and loss accounts.

Vendor's role post sale

Depending on the circumstances, the intentions of the vendor post sale may impact on the valuation.

Some purchasers would like to retain exiting principals on a consultancy basis to ensure an orderly transition of clients and management. Other purchasers may place more value on exiting the principal from the business at the time of sale. Obviously there are no concrete rules here, but it is an important consideration.

Premises

Premises commitments are deal-specific. Any purchaser would be interested in the duration of the lease commitment and how any lease incentives have been packaged. To reflect fair value, incentives should ideally be amortised over the duration of the lease. If a firm is committed to paying premium rent, having traded rent free for a period, this should be reflected in value.

In the circumstances where some partners are landlords and others tenants, a commercially reasonable lease – reflecting fair market value – should be in place.

Banks have traditionally seen value only in assets, lending on a safe percentage of WIP and debtors. Increasingly progressive bankers are lending on the intrinsic value of the business. Entering partners and purchases are able to finance their purchases, secured by the value of the business. Goodwill is alive and well in small, profitable firms. Any sale should be proceeded by a timely, rigorous valuation that considers all of the idiosyncrasies that set law firms apart from other small businesses.