SMALL FIRM SOLUTIONS

WINNING STRATEGIES FOR PROFITABLE FIRMS

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PRACTICE MANAGEMENT/M&A

SHORT-SIGHTED MISTAKES MADE IN DUE DILIGENCE

When valuing a business, historical data is a key concern, but proper due diligence also requires a strong focus on the future. A merged or acquired firm is a different entity from what it once was, and the effects of this transformation must be considered in sizing up any potential deal. Here are some examples in which data about the current firm don't tell the entire story.

Profitability. Most firms will invest considerable time to ascertain the current profitability of a potential merger or acquisition partner. While this is important, it is only the first step in understanding profitability. Let's look at a specific situation: Five years ago, there was a sole practitioner working from home with a spouse as the only administrative staff. This person generated $300,000 in annual fees and his net was likely 85%. Then this practitioner decided to move into an office and hire an office manager. He also wanted to cut back his own hours, so he hired a per diem person. All of these changes reduced his net to 45%. At which time was the practice worth more to a buyer or merger partner?

The answer is that the difference in net is irrelevant. This practitioner's net has nothing to do with the buyer unless it is taking over the operation and operating identically (same location, staff, time commitment, etc.). If the successor firm can absorb this practice into its own infrastructure with no or very few incremental increases in overhead, it is a very profitable acquisition. If it is necessary to take on additional space, staff or make any other changes that raise overhead that will certainly mitigate profit. Instead of worrying about current net for the existing firm, begin with the seller or merger partner's current net and then determine how much of it will accrue to the buyer.

Billing rates. Buyers and merger partners can have a similar blind spot about billing rates. In one recent merger, the mergeree was a sole practitioner doing approximately $400,000 in annual revenue with one paraprofessional and a per diem during the busy season. This owner was getting $150 an hour. He was to merge into a three-partner firm that had a manager and some seniors and juniors, but this firm was getting $200 per hour for partner time, $125 for manager, $90 for senior and $75 for juniors. At first the larger firm was quite concerned about the merger partner's lower billing rate. On closer examination, it was clear that 80% of the work the sole practitioner was doing could be passed down to managers, seniors and staff. The $150 an hour that he was earning for that work was in excess of the billing rates for the professionals in the successor firm who were to handle most of the work. Under the new arrangement, the mergeree was going to be freed up to handle the higher-level work of a partner who was soon to retire, earning the new firm's higher partner rate. By focusing on the future and not the past, the leaders of the larger firm realized the deal was a home run. There are many cases in which efficiencies in a new firm will optimize what a seller has to offer. In another merger, the seller's software was found to be far less efficient than the successor firm's. The successor firm estimated it would take them 20% less time to do an even better job for the clients than the seller was doing. That raised the billing rate realized without raising the fee to the client! Due diligence is a complicated, multifaceted process. In undertaking it, don't forget to assess not only a seller's current situation, but also how that firm's numbers may change in the new practice. You may be surprised to find how much more—or less—attractive the deal becomes. ☐

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