

The Cull-Out Sale: Partial Retention of a Practice

By Joel Sinkin and Terrence Putney

NOVEMBER 2006 - Many professionals think of their transition to retirement in black-and-white terms. Often they define succession as "One day I'll sell the company and retire." However, there are a plethora of ways to address succession that allow professionals to make a change in their organization and career short of the finality associated with an outright sale. One option is a cull-out sale.

A cull-out sale refers to an arrangement wherein a sole practitioner or professional firm elects to retain a portion of the practice and sell the other portion. The portion sold can be an office, a group of clients, or even certain services offered to all clients. There are a number of reasons to consider a cull-out sale. It can be a first step toward succession planning; it can increase profitability; and it can free up resources (including time) for a professional to pursue practice areas of greater interest, such as a particular niche.

Accountants sometimes use cull-out sales to sell excess individual tax clients so they can focus on business clients, or vice versa. A group of clients less desirable to one practitioner may be very desirable to another.

A Step Toward Succession

A case study can illustrate how a cull-out sale can work for succession planning. Consider a professional practice generating \$450,000 annually from traditional accounting and tax services. Over time, the practice's profitability had fallen to about 33% as the owner hired more staff to free up some of his time. He originally came to the authors seeking a "two-stage deal." This common technique allows the practitioner to affiliate with his eventual successor firm, remain in control of his client base, maintain a similar level of income, and continue to control the daily schedule. It also allows the practitioner and the successor firm to start the transition process, which should ensure a proper complete succession when the time comes. The technique is very useful when a practitioner is five or fewer years from a significant reduction in time devoted to client service. In this case, under these circumstances, a cull-out option was a good choice.

This individual reviewed his client base and selected approximately \$150,000 worth of clients he wanted to keep working with long term. These were clients who traditionally had required less handholding and paid good fees. They were also clients he felt personally connected to and enjoyed working for. After helping create parameters for an appropriate successor and valuing his practice, he was introduced to several firms, and he selected a specific firm to acquire the \$300,000 of business he was prepared to sell immediately. In addition to selling a portion of the firm, he acquired the rights to use the buyer's software and conference room facilities when needed, and negotiated a discounted rate for clerical support.

The buyer of the practice was thrilled because they acquired a group of very good clients who fit their target. By working out a means to keep the seller around, there was greater continuity for the client base, which resulted in high retention rates. The buyer also became gradually acclimated to the portion of the practice retained by the seller. As long as the buyer retained a minimum agreed-upon percentage of the purchased clients and made its payments on time, it received a right of first refusal to buy the remaining portion of the seller's practice at a later date.

The seller received strong compensation for the culled-out portion of the practice. He got access to an infrastructure to continue servicing the clients he retained, a practice-continuation agreement for retained clients, and the independence to continue running a practice as he desired. The retained clients took the seller less than 10 days a month to handle. Because of his greatly reduced overhead and the payments from the sale, the seller was actually making much more money despite working fewer hours.

Profitability

Most practice-management seminars focus on the need to get rid of the least profitable clients in a practice. The rule of thumb is that, in many firms, 50% of partner time is devoted to clients that generate less than 20% of revenues. Adding to the pressure to change is the fact that many firms have no excess capacity. Firms are encouraged to free up partner time to serve clients that generate more revenue per partner hour by "firing" the least desirable clients.

Maximizing the value of partner time is certainly desirable, but why get nothing in return? Why not find a new home for these clients and place them with a firm that covets their business? This is another excellent use of a cull-out sale.

The benefits of this approach for the selling firm are:

- The value of the client base culled out is realized;
- The selling firm avoids having to "fire" the clients, which can be very distasteful;
- Resources can be redeployed to a higher use or cut back; and
- In some cases, firms create excess capacity, which can be a tremendous catalyst for growth.

The culled-out clients find a new home with a firm that wants their business. They are not abandoned, and their information is properly transitioned to the buyer. They can now have security in the long-term continuity of their accounting needs. It is a win-win situation.

Specialty or Niche Practices

Many accounting firms offer specialty consulting services, such as financial planning, litigation support, business valuation, information technology, and CFO outsourcing. This has created a type of cull-out sale focused on practice niches. A very common scenario involves practitioners who have fallen in love with financial services and now loathe the compliance work they were previously doing.

The following is an example of just such a deal. Consider a two-partner firm generating over \$1,550,000 annually in traditional accounting and tax services and an additional \$475,000 in financial services and investment product sales. One partner sought to retire, the other partner desired to handle only the financial services business but recognized the accounting practice was crucial in maintaining relationships and developing new financial services clients.

The partners found a firm willing to buy only the accounting and tax portion of the practice. The buyer did not currently offer any financial services to their client base. The remaining partner moved into the buyer firm's offices, although he operated through a separate entity. The combination was held out as a merger motivated by a desire to provide more services to both client bases. The seller's clients continued to be provided accounting and tax services just as they had been accustomed to. They also were comforted in the fact that the retiring partner's transition had been addressed without any interruption in their service. The buyer's clients were provided access to financial services for the first time. Both firms benefited by achieving their strategic and financial objectives.

Pursuing Cull-Out Sales

Many issues need to be considered in pursuing cull-out deals.

- An noncompete agreement must be established to protect both the buyer and the seller firms.
- A referral program and agreement should create incentives for each firm.
- The valuation process for the portion of the practice being sold can be tricky.
- The transition plan for clients and staff should address the special circumstances created by these transactions.
- Risks for both firms should be addressed in the agreement, especially when the clients sold will be serviced by both firms after the sale.

It's always a good idea to get an expert to help with any acquisition or sale, especially with cull-out deals.

Potential Pitfalls

Both firms should be cognizant of the fact that there are potential obstacles to overcome and proper planning must be done. These include culling out a portion of a practice and selling it to a firm that will be interested. It is important that the interests of both the buyer and the seller are complementary. The example above might not have been successful if the buyer had already had a financial services practice. Even if the successor firm agrees not to compete, a potential conflict can arise.

Regardless of the niche, there can be clients who simply insist on remaining with the original owners while they are still in business. This kind of mindset can hamper the succession process. The best way to avoid these and other traps predominantly involves strong planning and open communication. Sellers should let clients know that the successor firm is now better suited to handle their needs because the old owners have now specialized in other areas and no longer can remain on top of both.

Good communication between the buyer and the seller about potential conflicts in advance, rather than after the fact, is the key. Potential client losses can follow a sale that is not properly planned.

Joel Sinkin and Terrence Putney, CPA, are partners in Accounting Transition Advisors LLC, which exclusively consults on the merger and acquisition of accounting and tax practices. They can be reached at 866-279-8550 or www.transitionadvisors.com.