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Voices Five variables when valuing a small firm

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The three most common questions we are asked by the firms we work with on M&A are:

- What is the multiple?
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Of course, the reference is to multiple of revenues, and the nature of the question is, "What should I be paid for my firm or what should I expect to pay when acquiring a practice?"

The value of an accounting firm is dependent on many factors -- the nature of the practice, it's size, how profitable the buyer thinks it will be, the perceived competition for the practice from other interested buyers, and its location, as well as many other factors. The most important thing to remember is, an accounting practice is not a commodity that sells for a common list price. Value is in the eye of the beholder. One person's floor is another person's ceiling.

However, there is a direct correlation between the revenue multiple and the other major terms of a transaction. Finding common ground between the buyer and seller in a package of terms is required for a deal to be completed.

The five variables you should focus on are:

1. Upfront cash investment. In most deals we have consulted on, the down payment in a straight sale is between none and 20 Percent of the expected selling price. What a buyer is willing to pay in a down payment can be heavily influenced by several operational issues. For example, closing on a tax-oriented practice just before tax season is more likely to warrant a down payment, compared to closing the same deal in May. Most of the annual revenue for that type of practice has already been generated by May, so the buyer will have to wait to obtain any profits and possibly operate the practice at a loss for the rest of the year. Most buyers are looking for a return on investment as soon as possible.

In most deals, the buyer is already making a significant investment to fund working capital, integration, training, marketing, and IT upgrades. In most straight sales the seller retains their account receivable and other working capital. It isn't unusual for the buyer to invest upfront 20 percent to 30 percent of an acquired practice's revenue before making any payments to the seller for the purchase. As a result, it

has become common in larger deals for buyers to request the use of the seller's working capital for a period of time to mitigate the negative cash flow that will be incurred upfront.

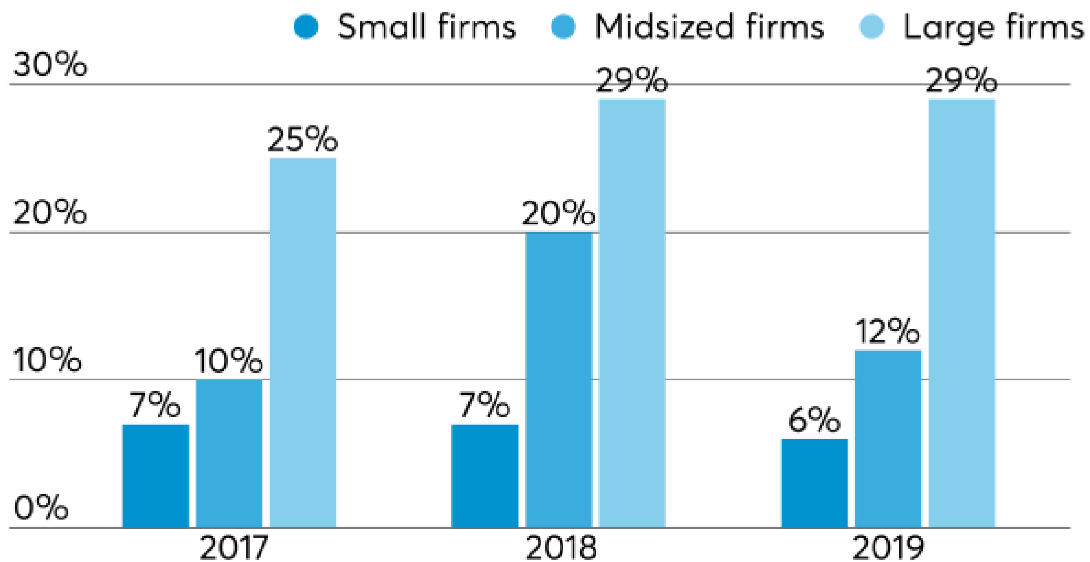
Therefore, the larger the down payment upfront a seller requires, the more likely a buyer may ask for concessions in other terms.

2. Duration of the retention period. This refers to how long changes in revenues post-closing generated by the seller's client base will impact the selling price of the practice. In over 27 years of consulting on CPA firm mergers and acquisitions, we have seen virtually no deals that were not contingent to some extent on post-closing client retention. The majority of deals we see are structured as "earn out" or collection deals. For example, if the seller were to be paid one times revenue over five years in an earn-out deal, the buyer would pay 20 percent of collections from the acquired clients for five years. Thus, the entire payout period is equal to the retention period. Some of the hundreds of deals we have consulted on used a limited retention period. For example, the price may lock based on retention after the second year even though the payout period is much longer. Retention periods of less than two years are becoming increasingly rare.

It isn't impossible for the price of an acquisition to be fixed at closing. However, in this case the buyer is forced to assume they know what the retention rate for the acquired clients will be based on very limited and no actual experience with those clients. If a savvy buyer was willing to undertake that much risk, it is likely they would expect significant concessions in the other terms, especially a much lower pricing multiple.

3. Profitability. When we refer to profitability, we mean the buyer's expected profit, not the seller's historical profit. In some cases there will be a significant difference between the two. If the buyer can absorb the practice with no incremental increase in overhead, capitalize on cost synergies such as savings in labor and rent, create revenue synergy through cross-selling other services, leverage work the selling owner was doing to lower-level staff, and pay the seller in a manner that provides the buyer a current deduction as opposed to long-term goodwill amortization, this increases the buyer's profitability. A buyer may be willing to offer concessions to make the other terms more lucrative to the seller in such a case. For instance, that buyer might offer a higher revenue multiple.

However, if the buyer firm is forced to absorb costs that it won't need, or will be unable to replicate the seller's profitability, a buyer may seek to offset that lower expectation of future profits through an adjustment in other terms. One of the things sellers have a tendency to overlook is the cost the buyer will have to incur to replace their own time. A seller that does most client work with their own time may appear to have a very high profit margin because accounting firms don't include partner cost in arriving at profit margins. Unless the buyer is in essence buying a job, however, most buyers will have to incur labor costs to produce the work and, therefore, can't replicate the seller's margin in that case.



4. Duration of the payout period. For small firms, most payout periods are typically five to seven years. Larger firms tend to be paid with longer payout periods, sometimes even in excess of 10 years. So, why does that make a difference? Buyers tend to evaluate the profitability of a purchase of a practice based on the cash flow that will be generated. The longer the payout period, the smaller the purchase payments, therefore, the greater the annual cash flow from the deal. A deal that will take three years to throw off any positive cash flow is hard to sell to the partners of a buying firm, especially given the upfront costs that the firm will incur, as described above.

A seller that requires a short payout period is likely to be asked to accept less lucrative terms elsewhere. However, the opposite is true as well. For example, if the seller was willing to accept a payout period of 10 years or more, the buyer might be willing to structure the deal as an asset sale because the intangible amortization period of 15 years and the payout period are not substantially different.

5. Multiple. Once again, the multiple is the effect, the first four variables above are the cause. It isn't always the case that the effect is reflected in the multiple, but it often is. Let's look at an example: Let's say we have a small, $750,000 practice that the buyer can absorb with no incremental increases in overhead. See the following valuation scenarios:

- Seller requires no cash at closing and will accept 12.5 percent of collections for 10 years. Many buyer firms would gladly accept these terms even though it results in a higher-than-average multiple of 125 percent.

- The same seller requires a 10 percent down payment, wants a five-year payout period, partially treated as an asset sale and partially treated as a current deduction (in the form of consulting payments), and a lock of the purchase price after the second year. Under that arrangement buyers in most areas of the country would only offer no more than a one times multiple and possibly less.
- In the third example, the seller asks for a three-year payout period, a one-year retention period, and the purchase is to be structured solely as an asset sale. Buyers in much of the country, assuming they would even consider those terms, would likely offer a much lower multiple, such as 70 percent or even less. Even though it is highly unlikely any buyer would accept these terms, if the same seller required all cash at closing, with no retention period and a full asset sale, such a seller could expect that the revenue multiple would be no higher than 50 percent.

In summary, the lower the down payment at closing, the more profitable the practice will be from the buyer's perspective (including the tax treatment of the payments), and the longer the payout period and retention period, the higher the resulting pricing multiple the seller should expect. And, the opposite is true as well.

Keep in mind this tip: Never negotiate one variable at a time. All five variables are interrelated whether you are the buyer or seller. When negotiating deals, make sure you are dealing with the full package of terms. If one of the five variables terms is more important to you than the others, consider offering a better deal for the other side on one of the other terms as an offset.

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