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Voices Why is your firm worth less than you think?

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We often run into partners in CPA firms who are surprised to find out that the recommended value for their owner's interest is less than their notions of what the practice would be worth in a sale. Sometimes their expectations for external value metrics are way out of line as well. However, most of the time the problem is just a matter of not understanding the economic reality of an internal transaction compared to an external one.

The rule of thumb in today's market is that internal valuations (defined as a multiple of revenues) are running roughly about 80 percent of the value firms can expect to receive in an outright sale.

Here are the four primary reasons why.

1. Your owner agreement is essentially a put option. Most owner agreements allow an owner to force the firm, or in some agreements the other partners, to buy out the owner interest of a terminated partner under certain circumstances such as a normal retirement. That contractual obligation resembles a put option for a publicly traded stock. Just like how the holder of a put option has paid a premium for the right to force a sale at a predetermined price, a discount from what might be considered market value is justified in an owner agreement.

2. Many owner agreements do not require an adjustment in price for client retention. It is very rare to find an external sale with terms that do not contain a post-closing adjustment if most or even all of the acquired clients are not retained by the buyer. In contrast, many owner agreements fix the price of the buyout of an owner's interest at the date of retirement. This feature normally requires that the retiring owner provide adequate notice of an intention to retire, often two years. (Note: If the termination of an owner's interest is due to other than a normal retirement, or if adequate notice is not given, many agreements will contain a retention provision.)

Client retention should be more certain in an internal transaction because the clients are usually being asked to accept less change. However, there does remain some risk of client attrition due to a change in a partner's relationship with clients and the normal risk due to matters that are out of the firm's control, such as an economic downturn, the sale of clients' businesses, and so forth. In an external transaction, if you had a choice of fixing the price at closing or basing the price on client retention, assuming you were even willing to fix the price, you'd likely expect a substantial reduction in the price in exchange.

3. A buy-sell agreement shields the owners from the uncertainty of the market. The price and the other terms of an owner's buyout are determined in advance of the transaction. Your owner agreement may have been negotiated many years ago and may be based on market conditions that no longer exist. Even if your agreement was recently executed, you know what to expect with your owner agreement terms. If you sell your firm, you are subject to whatever the market will bear and your ability to find the best deal. That peace of mind should be worth something and justifies a lower price.

4. There are distinct advantages to an internal transition including legacy. We find most partners prefer an internal transition over a merger or sale for many reasons. An internal transition creates less disruption to the firm and the partner's personal routines. They can control more of the things that define their relationship with the firm. There is a lot of uncertainty in how their day-to-day experience will change in a merger or acquisition.

Our experience is that most mergers work out extremely well for the partners of the acquired firm. However, many partners still have some trepidation about how a merger or sale will turn out for them personally. Plus the firm's legacy is important, especially to the founding partners. In most sales, that legacy will be lost. So in order to make sure the firm and the next generation of owners can make an internal sale work, more favorable terms are often a good trade-off for more assurance of maintaining the firm's existence.

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