How to Properly Value Your CPA Firm

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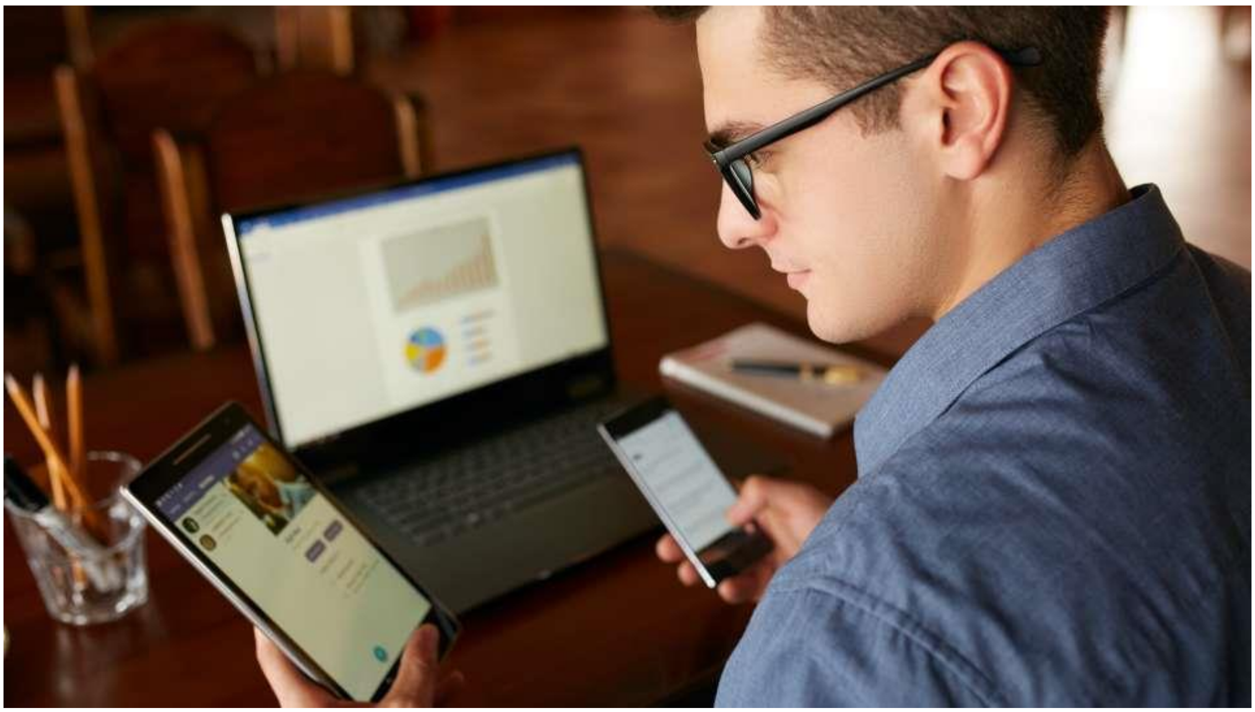
Firms looking toward an external succession via a merger want to know what they should expect to be paid, or conversely, those looking to acquire a practice want to get an estimate of what they would pay in today's M&A market.



In the almost 30 years we've been helping CPA firms with succession issues inarguably the most frequent questions we get asked are:

- What's the multiple?
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Simply put, unfortunately, there's no standard answer. From a buyer or seller's standpoint firm values hinge on several factors. For example, what type of practice it is – i.e. standard tax and audit vs. specialty niches; the perceived profitability of the practice; location – metropolitan vs. rural market, updated technology etc.

Value is often in the eye of the beholder – one person's floor is another's ceiling. But a consensus on a package of terms is essential for any deal to be completed and more importantly to be successful. This article should help you understand the variables that serve to calculate a fair and accurate multiple whether you're a seller or an acquirer and it will also provide some current examples of diverse firms and what they can expect to receive in terms of valuation.

Marketplace Changes

As recently as 15 years ago, the M&A market overwhelmingly favored seller firms. During the years leading up to that time it was not uncommon to see firms receiving multiples as high as 1.5X or 1.75X. Meanwhile in the late 1990s and well into the 2000's, big consolidators such as American Express Tax & Business Services, Centerprise, H&R Block and CBIZ were rolling up CPA firms on an almost daily basis paying multiples that on occasion even approached 2X. But that was then, and this is now.

Staffing shortages and a massive void in the talent pipeline have left firms with less capacity than in the past, making them unlikely suitors for firms where partners and staff need to be replaced. Firms owned by Baby Boomers are hitting the market en masse as sellers and that will continue for the foreseeable future.

The supply of sellers is starting to outpace the demand from buyers allowing buyers to become more selective and therefore depressing values. Many profession pundits suggest that soon traditional services provided by accounting firms will be taken over by artificial intelligence.

Meanwhile, blockchain technology may depress the need for audit and accounting services. This has made some buyers leery of acquiring firms with traditional practices for fear much of the fees generated by these services will decline if not be lost altogether several years down the road.

There are exceptions, however. Some geographic areas have a high density of small CPA firms which tends to attract an adequate pool of buyers. Practices with strong consulting niches are more in demand now than traditional A&A and tax firms.

A firm with strong young talent is also a more attractive acquisition. Based on what the future market appears to look like, the trend of decreasing valuations and declining demand will continue.

Variables in Valuing a Firm

Determining a firm's multiple is should be viewed as cause and effect. It's critical to remember that the multiple is the effect – determined in large part by several distinct variables, which we refer to as the cause. Let's examine each in depth:

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 prior to tax season is more likely to warrant a down payment, compared to closing the same deal in May when most of the billings have been collected.

In most deals, the buyer is already making a significant investment to fund working capital, integration, training, marketing, and IT upgrades. Most acquirers are looking for a return on their investment as soon as possible.

2. Duration of the retention period

In nearly 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 and have helped facilitate 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.

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.

3. Profitability

When I refer to profitability, I’m referring to the buyer’s expected profits from the deal, not the seller’s historical profit. In some cases, there will be a significant difference between the two. The buyer can increase profitability and hence the multiple the seller can expect to receive if they:

- 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
- pay the seller in a manner that provides the buyer a current deduction

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 integration costs that the firm will incur and thus affect the multiple.

5. The Multiple

Once again, the multiple is the effect. The above 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. Note the following valuation scenario: 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 1.25 percent.

Strategies to Boost Your Firm's Valuation

If you have ever put your house up for sale you know what it takes to make it more attractive to potential buyers. You stop procrastinating with those repair tasks – whether large or small – and you may even call in a consultant to professionally "stage" the interior and exterior.

It's no different with a CPA firm. There are strategies you can implement to increase the value of the practice and at the same time make it more attractive to potential suitors:

1. Embrace technology

Let's face facts, in today's public accounting landscape if you firm is not paperless, using cloud applications or working with client portals, your IT culture is rooted in the 20th century and as a result many potential acquirers will look for their next merger elsewhere.

It can cost as much as $12k per full time equivalent post-merger to bring a seller firm up to date on your IT platform. But aside from cost a bigger reason is culture.

Recently, a firm we were consulting with was looking at two firms. Firm A had excellent metrics but had not embraced technology. Firm B had average metrics but had a sophisticated IT platform.

A partner at the buyer firm chose to go forward with the firm that had embraced technology. The reason? She explained that it took years to get her team comfortable with being paperless, working on the cloud, and offering remote access. She said that she could make a firm more efficient but couldn't always change a long-standing cultural mindset of relying on paper.

2. Adopt a "brand" versus "partner" loyal culture

If your clients will only speak with one person in your firm and most, if not all your relationships are "partner" loyal, that means transitioning clients will be more challenging. Trying to get your clients more "brand" loyal, where clients are comfortable speaking to two or more team members – moving to a to a "one firm client" philosophy can be a very attractive culture to a successor firm.

3. Have good clients and staff

Every firm has a "basement" and "ceiling" of good and bad clients. Often, I have heard a potential successor firm tell me that a seller firm's basement is "too deep" meaning that many of their clients were billing too low to make the deal profitable.

Last year, a firm I had been working with a seller firm who determined that roughly 10 percent of their revenues stemmed from C or D-rated clients and prior to going out to the marketplace wisely dismissed those clients. The firm we consulted on recognized that only 10 percent of their revenues came from grade C or D clients and before they went to the marketplace to merge up, they fired those clients.

They didn't want to be defined by the few $300 1040s they were preparing. Good staff who have strong technical and people skills, youth and signed employment agreements that contain a non-compete can be a separator between firms.

Good staff can be a very strong attribute a successor firm may covet. Meanwhile, the clients a successor firm is confident they can retain are obviously an enticement.

4. Niches

As noted before, many of the traditional accounting services will eventually be replaced by technology, having strong niches add to your firm's appeal. Wealth Management, HR consulting IT consulting and outsourcing are just a few of the in-demand service niches that could make your firm stand out from the competition.

If you don't have a niche as an alternative selling point you may be able to determine if your clients would be receptive to certain specialties. Identifying a firm that offers service niches you're confident your clients would welcome is a smart strategy to apply.

5. Realistic terms
It's critical to have a realistic view of your firm's value. Last year we were confronted by someone seeking to sell their firm and taking the position they paid 1.5X to acquire this firm 15 years ago and weren't going to accept less. Of course, a year later we heard they were still seeking a deal.

Final Thoughts

For partners seeking succession, while you should not be Santa Claus and give your firm away, remember that no one will acquire your firm to lose money let alone break even. For firms seeking to merge, no one will be doubling your pay if you merge with them.

While a firm merging up has the right to assume if they bring in similar revenues and invest the same time, barring few exceptions such as the case of a seller's quality control process that needed more labor to rise to the standards of the successor firms', setting realistic goals so everyone wins makes your firm more attractive and valuable.