What is Your Practice Worth in the 2013 M&A Market?

By Gary Adamson, CPA

Tax Season 2013 is over and the M&A frenzy will pick back up again where it left off. So, what is your practice worth? What can you expect whether you are a buyer or seller? One thing is for sure – Baby Boomers are selling at a rate that the profession has never seen before. It is still a sellers market, for now. But the demographics and the thousands of practices that will soon be for sale suggest that may change over the next few years.

We are often asked by our clients about the market and what firms are selling for. Everyone wants to know "what's the multiple?" Let's start with a little bit of background and definition. First of all, there are basically two types of deals in the CPA firm M&A world. One is a "merger" transaction where generally, partners of the smaller firm join the larger firm with the key characteristic being that those partners plan to continue with the larger firm on more than a short term basis. Normally no cash changes hands. Rather the incoming partners are brought into the firm's existing deferred compensation /partner buyout plan.

The second is really a purchase where the partners or sole proprietor of the smaller firm are selling the practice and are not continuing on a long term basis with the larger firm. These tend to be the smaller deals. Often, a single transaction will combine a merger approach for some incoming partners and the buyout of others.

This article is focused on the purchase transaction. At the smallest end of the spectrum are the cash deals. In spite of lots of talk, we just don't see them. In fact, they are almost non-existent in the firms that we work with. The generally accepted deal structure for most purchases in the profession today is a multiple of revenue approach paid out over a period of time, with no interest.

The first question we get from our clients is usually "what multiple of revenue are practices selling for?" We normally answer that question with another question: As the buyer would you take this deal: a $500,000 tax practice, good rate per hour, located in your back yard, zero or a small down payment, good transition of clients by the retiring sole practitioner, and the price is 15% of collections over ten years. There usually is a short pause and the answer is "yes, absolutely." So far I don't think we have heard a no.

In the preceding example, as the buyer you just said yes to paying a multiple of 1.5 times revenue for the practice! What?? Why would you do that? The point is it’s not just about the multiple; it’s about the overall deal structure and terms. The multiple is only one piece of the puzzle.

Although we won’t touch on everything, the important components that go together to make up and influence the structure are:

- Size of practice
- Profitability of the practice
- Location
- Down payment
- Term (number of years) of the payments
- Length of time before the purchase price is fixed
- Extent and quality of client transition
- And finally, the multiple of revenue being paid

The relative size of a practice being acquired will have an impact on the pricing of a deal. Generally, the larger the target, the fewer potential buyers there will be and the price is lower. Likewise the pricing is impacted by the location of the target. If you are in a major metro area there are more potential suitors and you can command a higher price.

Be careful on analyzing the profitability of the practice. Most of us want to focus on the financials of the target and yes, we do want to review and understand them. But as the buyer, the more important questions should be the margins and profitability in our firm. What is it going to look like in our shop? Cost structures are different and how we staff it may be different.

The down payment, length of payment term and when the price is fixed or locked down all work together to influence the multiple. As you can probably imagine, as the down payment goes up the buyer has more risk and the multiple may go down. A down payment of more than 20% is fairly unusual in this post recession market and we often see any down payment treated as an advance on the first year or two of payments. The length of the payment term is normally in the range of four to six years and the multiple will be higher as the term increases.

The lock down of the price deserves some explanation. In our $500,000 tax practice example there is no lockdown and the seller would have received 15% of collections or $75,000 for ten years, assuming that the revenue stayed at the $500,000 level. Of course, it won’t stay at that same amount. Hopefully the acquiring firm is going to grow it but most sellers are worried that it will shrink. To protect against that shrinkage, sellers want a lock down or fixing of the price after some period of time. We normally see that in the one to three year range. So, if in our example we included a two year lock down, the value would be fixed at the end of two years based on the revenue of the practice at that time. The remaining payments would be adjusted accordingly.

The length and quality of the transition to be provided by the exiting partners or sole practitioner is critical to the retention of clients and the value of the practice. The interplay of the transition and the lock down of the pricing is key.

So, what about the multiple? We see a lot of transactions in the 1 to 1.25 range, with the higher end of the scale in the metro areas. That would assume terms in the “somewhat normal range” such as a down payment of not more than 20%, a five year payout, a two year lock down, good transition, etc.

A few more details to be aware of include:

- Furniture and equipment are normally included (the buyer receives them).
- Work in process and accounts receivable are normally not included.
- As the buyer, always share the upside prior to the lock down with the seller.
- Make sure that your transition plan includes two cycles.

For a little bit more information, in a recent article available on our website, we shared what sole practitioners are thinking regarding multiples and terms in the sale of their practices. Our source was the 2012 Succession Survey conducted by the Succession Institute in cooperation with PCPS.

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