# How to Value a Law Firm You are Contemplating Acquiring

For attorneys and their law firms, growth comes in just two flavors: organic or acquired. Theoretically, organic growth, once a law firm figures it out, could lead to meteoric growth. The problem is that organic growth has its limits.

When law firms decide that there are areas of law or geographies they do not practice in but should—possibly because they would be complementary to an existing practice or location—organic growth probably isn't going to cut it. After all, a law firm can't simply market itself and its attorneys into an area of law or a state in which they don't have a presence.

That's where law firm acquisitions come into play.

But law firm acquisitions come with a host of questions that a would-be acquirer must ask. The most important question might very well be: "How much should we pay for that other law firm?"

As you might expect, the answer is not straightforward. That's because when a law firm buys another law firm, it is buying two separate things: that law firm's "business" and that law firm's "practice."

While there is an entire industry built around valuing law firms for the purpose of facilitating mergers, below are some law firm valuation basics that attorneys should know as they begin exploring the acquisition of another law firm.

## VALUING THE BUSINESS OF ANOTHER LAW FIRM

In this context, the “business” of another law firm is the assets and obligations that law firm’s business entity owns or is on the hook for.

When a law firm acquires another law firm, the acquiring law firm may be purchasing assets and obligations that include the target firm’s:

- Cash on hand
- Prepaid expenses
- Land, building, improvements or lease
- Office furniture and fixtures
- Equipment such as computers, telephones, copies, faxes and the like
- Loans and lease obligations
- Accounts receivable
- Accounts payable
- Unbilled fees and client costs
- Client funds held in trust

Generally speaking, the business of a law firm is valued on the net book value of the firm’s cash basis balance sheet.

Even when factoring in the need to establish values of aged equipment that might need to be replaced in the coming year or two, or client fees that have been billed but are unlikely to be collected, an acquiring firm should be able to value these assets and obligations fairly easily.

An acquiring firm should consider requesting from the target firm documents that would help the would-be acquirer develop the valuation, including:

- Financial statements
- Federal income tax returns
- Titles to assets
- Bank statements and records
- Debt agreements
- Leases and subscription agreements
- Business and payroll tax returns
- Insurance policies and applications
- Compensation records for attorneys and staff

There’s other valuable client information to discover too, including things like their fees paid vs. owed and time billed by the firm to those clients’ matters.

These documents will also assist a would-be acquirer in determining the value of a target firm’s practice.

## VALUING THE PRACTICE OF ANOTHER LAW FIRM

In this context, the “practice” of another law firm is what allows that firm’s business to earn revenue.

It is the knowledge possessed by the law firm’s attorneys, along with the attorneys’ networks of referral sources, professional contacts and other people who have helped the law firm generate revenue in the past and will help it generate revenue in the future. It is also, in a way, the goodwill possessed by the law firm’s name and its attorneys which enables it to draw business from referral sources and professional contacts.

### Asset-based Valuation

Some would-be acquirers use an asset-based calculation which uses deceivingly simple math: add up a firm’s assets, subtract its liabilities and get a net value. This focus on assets and liabilities means the valuation is driven by the business of the law firm and not the practice. This valuation does not take into account a firm’s earnings or cash flow—two vitally important metrics of a firm’s financial well-being. For this reason, an asset-based valuation is not a popular valuation method.

### Valuation Based on Previous Transactions

Theoretically, basing the value of a law firm on what similar law firms sold for would be an efficient and effective means of valuing that firm. The problem is that the prices and terms of these transactions—whether they are among two separate law firms or among partners within the same firm—are rarely made public.

Even if the prices were publicly available, a would-be acquirer would still be partially in the dark because unique circumstances that are not visible or known to the public could have caused a previously acquired law firm to be valued differently than a seemingly similar law firm that the would-be acquirer is contemplating purchasing.

### Valuation Based on Cash Flow

This method of valuation is based on projected future financial performance of the target firm. Specifically, this method produces a valuation by estimating a firm's future cash flows (typically based on the past five years' worth of financial statements), and the expected rate of return attorneys would reasonably expect on those cash flows.

### Valuation Based on Multiple of Earnings

A valuation method that is commonly used outside of the legal industry—a valuation based on a multiple of earnings—also tends to be frequently used within it.

Here, a value for a law firm is determined by averaging, typically, the past five years' worth of that firm's gross fee revenues. Then, a factor of between 0.5 and 3.0 is applied, depending on a number of considerations revolving around the expected ability for those revenues to stay the same or increase in the future.

These considerations may include everything from the target firm's location, to the affluence and profitability of the firm's client base, to whether the firm's clients provide repeat business, to whether the would-be acquirer will be able to properly transition those clients to its firm. The more likely that an acquiring law firm will be able to maintain or exceed the amount of the target firm's average gross revenues when it becomes part of the acquiring firm, the higher the multiple.

## A SIGNIFICANT UNDERTAKING REQUIRING A SIGNIFICANT INVESTIGATION

There are few things in the life of a law firm more monumental than acquiring another law firm. Such an undertaking requires a thorough investigation, particularly around the price the would-be acquirer should pay for that firm.

With an understanding of the valuation basics we've described above, would-be acquirers will hopefully be in a better position to understand from the get-go the work that will be necessary to determine how much money they should pay for a law firm they are contemplating acquiring.

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