Succession Planning—Valuing Partner Equity in Larger Firms

By Joel Sinkin and Terrence Putney

"What are firms going for these days?" That is the first question we hear from a firm when addressing succession or transition of ownership. Usually, the expected answer is somewhere between 1.25 times and .8 times fees. However, we are not dealing with a widget manufacturer or a retail store. The value of an accounting firm is an intangible that is based primarily on an assessment of the relationships the firm has with its clients. The firm's value lies in the probability that those relationships will transition to a successor partner. The terms of the deal are critical since they are what motivate the parties to have a successful transition. Therefore, the answer is not simply a numeric amount: it is a numeric amount plus the specific terms of the agreement. In an article in the October 2009 issue of this journal, we addressed how to determine whether an internal or external succession plan is the better option for the partners in your firm.

Succession planning is the foundation that creates a successful transition of client relationships. This article discusses how to capture and measure the value of the firm once the succession has commenced. We

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Succession Planning

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will address valuation issues for both internal succession and external transactions (mergers or acquisitions).

A litmus test for internal-succession valuation

Most accountants have helped clients buy a business. Even if not specifically involved in the valuation, the accountant generally assists in analyzing whether the deal is "good" for their client. Can you imagine telling your client "You will break even at best, and perhaps lose money over the next five years. But it is a great deal and you should do it." If you would advise your client not to accept such a deal, you should not expect your partners to accept it. Yet, many internal valuations are set up in a way that acts as a disincentive for young partners to buyout senior partners. Where is their economic reward?

Here is an example of the litmus test:

> Let's say that a partner seeking to retire is currently making $300,000 per year. Now suppose the firm can replace the productive capacity of that partner for $125,000 in labor. We don't mean that you can hire a partner off the street with the same skill set and 35 years experience for $125,000; we do mean that by having other partners assume some of the retiring partner's role and doing some other internal shifts of responsibility, the firm can get the job done for that amount in labor cost. That leaves the$175,000 left over from the retiring partner's compensation.
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> Several issues now need to be decided. From the remaining partners' viewpoint, what remains to be determined is how much of that remainder ($175,000) goes to the retiring partner in the form of retirement payments, how much is retained by the remaining partners and how long the buyout period will continue. The retiring partner has other priorities: being compensated fairly for the value in the firm he or she has built up over the years and creating an incentive in the form of increased income for the remaining partners to take the risk and additional responsibility necessary to make it happen. Regardless, in using this formula, the retiring partner retires and receives value for their years of sweat equity and the remaining partners make more money.

Factoring in client-transition risk

There is significant risk that clients will not successfully transition from a retiring partner to a successor in every deal, whether it is an internal succession or an external transaction. A properly structured deal takes this risk into account.

In an external deal, the successor normally does not have a history with the clients, and there is virtually no way to assure the transition will be successful. Therefore, in almost all external deals, the value is based on actual post-closing retention. This is the primary justification for collection-based deals (although alternative approaches are used as well).

In an internal deal, the clients might be more "partner loyal" than "brand loyal." Still, the clients have a relationship with the firm that can be leveraged through the use of a succession plan that requires the retiring partner to give a set amount of notice (generally two years) of their intent to retire. This two-year window gives the firm enough time to transition client relationships and evaluate how the client-new partner relationship is working. This allows the value of the retiring partner's interest to be determined and fixed as of the retirement date on the assumption that anything bad that was going to happen due to transition has occurred by then. In these cases, the penalty for failure to provide adequate notice is often making the payments subject to adjustment for any client attrition during the first two years after retirement.

There are exceptions to these general guidelines:

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- A large concentration of billings in one client group may require a more collection-based approach because there is greater risk of a significant loss of revenue.
- Consulting projects that constantly have to be resold may need to be taken out of the mix because renewals of the engagement never are certain.
- Other factors, such as economic conditions in a specific industry group where there is too much uncertainty about the ability of the firm to maintain historical fees to a group of clients, need to be reviewed on a case-by-case basis.

Valuing the firm on an internal sale

Firms over $25 million. Most U.S. firms with over $25 million in revenues use compensation-based formulas for retirement payments. The multiples used are generally in the range of two to three times annual compensation per partner. The recent trend has been a decrease in the multiples used. Many larger firms are now in the range of two to two-and-a-half times. Usually the payout period is in a range of seven to 12 years.

As an example, suppose a retiring partner averaged $300,000 in compensation for the past three years. The firm's retirement formula is three times compensation paid over 10 years. In this partner's case, the total payout is $900,000, paid out as $90,000 per year for 10 years.

Firms under $25 million. Generally, smaller firms still use a formula-based system that is based on the portion of the firm's equity owned times a valuation multiple applied to the firm's total book of business. The range runs from .6 to 1.25, although the most popular multiple remains one times. The reason for this approach in smaller firms is they tend to have a larger variance in the amount of equity owned by a partner. Larger firms have moved to more equality in equity ownership.

Consider this example: A retiring partner owns 25 percent of a $5 million firm that uses one times as the valuation multiple. The retiring partner will be paid $125,000 per year for 10 years ($5 million times 25 percent times one, divided by 10).

Smaller firms also may use an approach based on valuing the book of business managed by an individual partner as the basis for the retirement or buyout. This occurs typically in "silo" firms that do not have a single-firm culture.

Other considerations. Once the total buyout or retirement payments are determined using one of the above techniques and the payout period is set, the rest of the terms tend to be as follows:

- Interest is normally not paid on the deferred payments; adding six-percent annual interest, compounded monthly to a 10-year payment stream increases the payments by 33 percent and can make the plan totally unaffordable.
- The tax treatment of the payments is frequently in the form of ordinary deductions/income as nonqualified deferred compensation or acquisition of a partnership interest. However there is an increasing trend toward utilizing the significant disparity in the tax rates between capital gains and ordinary income (plus social security taxes in some cases), and some firms are using structures to treat the payments as the acquisition of a capital asset. This technique can be tricky, and depends on many factors that are beyond the scope of this article, and typically reduces the overall multiple.
- The firm's tangible equity (accrual basis book value) is normally paid out in addition to the above valuation, over as little as a few months up to the total payout term for the intangible equity. Most often, a multiple-year payout of tangible equity is recommended, as this is the firm's working capital, and it will have to be replaced out of future cash flow. That said, we have seen firms that increase the multiple and, as a result, do not include any capital-account-type of payments.

Whether a firm uses the compensation approach or the equity approach, it is still critical the plan passes the litmus test, meaning payments can be made from the residual amount of the retiring partner's foregone compensation.

Cash flow safety net. We usually recommend a cap on the amount of revenues that can be paid in any year to retired partners. The range runs from five percent to as much as 15 percent, depending on firm size and profitability. This is to protect the firm's survival and is in all parties' best interests.

Post-retirement compensation. Many retired partners

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want the ability to stay on in a part-time role. There are several advantages to including this option in the retirement plan or partnership agreement:

- Retired partners staying around can help promote client retention
- Partners having that option are more likely to leave their full-time role earlier, freeing up their spot for younger partners
- These retired partners have significant skills (not the least of which is practice development), and those skills can benefit the firm

We often recommend retired partners be paid 33 percent of what they are billed out for on each mutually agreeable task. We usually recommend that they also be paid for new-client referrals to motivate them to continue to do that. In cases where significant nonbillable tasks are expected of the retired partner, that time should also be compensated.

Valuing the firm equity to an external buyer

When valuing the firm in an external sale, the following five variables within the terms are the most important for establishing the true value of the deal: (1) cash upfront, if any, (2) retention adjustments, (3) profitability, (4) duration of the remaining payments, and (5) multiple of revenues.

Cash upfront. The amount of money upfront is one of the variables that has been most impacted by the economy in current deals. Cash flow and credit are tight. As a result, we are seeing much less cash paid at closing and many deals with no cash paid at closing. The top end of the range is around 20 percent. The irony of this variable from the seller's point of view is the amount of cash paid at closing has nothing to do with the total payments he will receive. But it has a lot to do with the number of firms willing to do a deal and therefore can affect the quality of the acquiring firm. The quality of the acquiring firm is the most important attribute affecting the next variable, client retention.

Retention adjustments. The economy has caused an increase in client attrition in many firms. Therefore, buyers are trending toward longer retention periods because they perceive there could be significant attrition they have no control over.

Profitability. Many buyers make a critical error in this variable, as they base everything on the seller's current profit and billing rates, as opposed to what these factors will be in the hands of the buyer or after a merger. For example, if the selling firm is currently using partners to perform work the successor firm would typically use managers and seniors for in the larger firm, the smaller firm's partner billing rates may be less than the successor firm's partner billing rates, but greater than the managers and seniors; thus, the impact is not negative. However, after the merger, those partners can probably raise their rates by doing more partner-level work, which should bring additional rewards. The same theories apply to profit. If the successor firm can acquire the firm with not much incremental increase in overhead, the profit from the synergies realized may make this more profitable for the successor firm than it appears to be today for the selling firm. Profitability can also be affected by assumed costs, such as leases or excess employees the seller requires the buyer to hire. Finally, one of the biggest factors affecting the buyer's profitability is the tax treatment of the payments.

Duration of the remaining payments. The range in today's market for external deals tends to run between five and 10 years for the remaining payments. This can be an important tool for making a deal a win-win for both parties. If the seller is seeking a premium multiple, like 1.15 times, the buyer may be able to make that affordable by stretching the payment period by one or two more years.

The multiple. The multiple has purposely been positioned in this analysis as the last variable because the multiple is the effect. The first four variables are the cause. The less money upfront, the longer the payout and retention periods are, the more profitably the deal is structured for the buyer, the higher the multiple tends to be. Obviously, the opposite applies as well. Deals that are structured to create better cash flow for the buyer tend to command a higher multiple.

Supply and demand

Another factor that impacts the valuation is the supply of buyers and how much in demand a particular practice is. If the firm seeking a sale is in a remote area, and there are very few firms desiring a location in that area, the laws of supply

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and demand (in this case, lack of demand), will negatively impact value. Firms in larger metropolitan areas naturally command a higher multiple.

The size of the seller firm has a similar impact on value. The larger the firm, the fewer potential buyers. In many markets, there can literally be dozens of small to mid-sized regional firms who are seeking a merger to assist them in future succession, but there may only be a handful of firms with the professional and financial assets to effectively do the deal. Thus, the supply-and-demand curve can cause that market for that size firm to be a buyer's market. This realization appears to be part of the reason we are seeing more mergers today of mid-sized firms. They want to secure their affiliation now before they become one of many seeking that solution in the near future in a market unable to accommodate all of the supply.

The impact of the economy

Between 2004 and 2008, it wasn't uncommon for firms to grow 10 percent to 20 percent organically, and no one could find enough competent staff. The market shifted dramatically in 2009. Growth has been replaced with client attrition, receivables are building up and staff is readily available. In the past, most of our buyer clients only wanted to merge or acquire with firms to acquire talent, special expertise, niche services and young partners. The acquired client base was almost secondary. Today, most of our clients are ready to also look at firms with retirement-minded partners because they need acquired revenues to sustain growth.

Contrary to most predictions, there has not been a decrease in valuations. Instead, deals are available for sellers who are open to terms with little to no upfront money, reasonable retention and payout periods, and who agree to other stipulations that sweeten the deal for the buyer. The value of such deals actually is higher than they were just last year. For firms up to with several million dollars of revenues, their value in 2009 is probably more than in recent history.

Firms that still are insisting on large down payments and fixed purchase prices without retention adjustments are finding the opposite: the market is more dire than in the past as many firms are unwilling to assume those risks in today's economy. Retention periods and upfront money requirements are clearly being scrutinized more.

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