Valuation of Law Firms

Five Key Factors

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Introduction

It is quite remarkable how little law firm owners know about the value of their firms. Although they must wonder how much their firm is worth and have those conversations among themselves and with their accountants, they rarely spend time looking at this.

From my experience, law firm owners do not fully appreciate the value of what they have created and often have a lower market valuation in their heads.

It has become an industry cliché to say that valuing a law firm is more an art than a science. Perhaps it is no more than stating the obvious that valuation is in the eye of the beholder.

There is truth in both of these statements since law firm valuation is impacted by several variables, not all of which can be quantified, and the perception of the future prospects of a law firm can be quite different depending on the biases of the parties.

So how do you determine the value of a law firm, given that it is a 'people' business?

Valuation should take into account these 5 critical factors, which can be evaluated using different methodologies.

1. Choosing the Right Valuation Method

Law firm valuations are very controversial, but there are a number of valuation models that exist, with the more sophisticated ones being applied to larger law firms.

Most have in common the use of multiples, which are described below.

Valuation multiples for law firms in the UK can vary widely depending on several factors, including the firm's size, practice areas, profitability, reputation, and geographic location.

While there is no fixed standard for valuation multiples in the legal industry, here are some general guidelines that may help provide a rough estimate:

Revenue Multiple

This is one of the most common valuation methods for law firms. It involves multiplying the firm's annual revenue by a certain factor. Revenue multiples typically range from 0.5x to 2x or more, depending on the firm's characteristics. Larger, more profitable firms with strong client relationships and growth potential may command higher multiples.

Earnings Before Interest, Taxes, Depreciation, and Amortisation (EBITDA) Multiple

EBITDA is a measure of a firm's profitability. Valuing law firms with a stable and consistent EBITDA can be done using multiples that range from 3x to 8x or more, depending on the firm's specific attributes. There is also a link between scale and higher multiples.

Profit Margin Multiples

Valuing law firms based on their profit margin instead of revenue or EBITDA is common practice. Profit margin multiples are typically higher for firms with strong profitability. These multiples can range from 10% to 50% or more of annual revenue.

The book value multiple is a measure used to evaluate the value of a company

The book value of a law firm represents the difference between its total assets and total liabilities. Valuation based on book value is less common in the legal industry but may be relevant for firms with substantial tangible assets, such as personal injury and clinical negligence. Book value multiples can vary widely but are generally lower than revenue or EBITDA multiples.

Comparable sales and transactions

One can also value UK law firms by examining recent sales or transactions of similar firms based on size, practice areas, and geographic location. Analysing these comparable deals can provide insights into the market multiples currently being paid for law firms.

2. Gross profit: higher valuations correlate with higher gross margins

Gross profit is defined as revenue less the cost of sales to achieve that revenue. Often, partner salaries are included in the cost, so an adjustment should, of course, be made.

High growth and high profitability are the business nirvana that all law firm owners want to reach. However, it can be difficult to maintain. Operating at this level means that you are experiencing both high growth and high profitability, but not everyone is able to make it here for very long, particularly as scale increases.

Any buyer will be looking at cost synergies from the outset, and this is what needs to be understood by any seller. When a smaller firm joins a larger firm, the larger firm can significantly reduce high costs related to professional indemnity insurance. Back office costs can be significantly reduced by a larger firm, and revenue can also go up as the fee income per partner may increase as the burden of compliance and management is lifted by central resources.

Buyers will pay particular attention to gross margins.

The average gross margin for law firms in the UK can vary based on several factors, including the size of the firm, its practice areas, and its overall business model.

Gross margin is typically calculated as the percentage difference between revenue and the cost of services, which is the direct cost associated with delivering legal services.

Benchmark reports in this sector can be very misleading, as we have seen top-performing firms with margins over 50% and poor-performing firms below 10%.

However, fee earner gearing (the ratio of fee earners to equity partners) is a key indicator, not only as an absolute measure but also as a trend over time, so once again, care has to be taken when using gross margins as a key determinant.

3. The Future Growth Story: Storytellers and Number Crunchers

"Valuation that is not backed up by a story is both soulless and untrustworthy and we remember stories better than spreadsheets" – Professor Aswath Damodaran, *Narrative and Numbers: The Value of Stories in Business*.

Firms also forget that their story, their history, and their people can be as valuable as the numbers that are crunched.

If the firm is growing, the narrative has to be a growth story with a detailed plan that makes sense; it can be a few bullet points and does not have to be War and Peace, but it has to make sense with some numbers, e.g., increasing revenue by X within the next 3-5 years, etc.

A growth law firm that can be scaled up offers more realistic opportunities for higher multiples, unlike a static firm.

Savvy buyers are paying for the future, not the past.

4. The Succession Trap

I frequently deal with SME law firm owners who want to extract as much as possible from a sale but want to leave as quickly as possible, which is a real red flag for buyers.

Here is the problem: why would a buyer pay anything if the partner(s) and those close to the main clients have exited? Frequently, I see very profitable firms worth almost nothing because they do not have a succession plan.

It is difficult to know why this is the case, but it may be due to problems in getting the right talent or concerns about losing clients. Perhaps there is a more straightforward reason: they have simply not thought about the strategy behind an exit, which will usually involve some succession planning.

A succession plan agreed upon with any buyer can easily resolve this issue. This may mean a longer earn-out period. One possible solution could be a price reduction to account for the costs associated with promoting lawyers to take over, among other factors.

5. Professional indemnity insurance and regulatory issues

How often have we seen firms with real value encounter exit challenges due to a poor claims record or regulatory issues?

From sloppy fee earners to misconduct issues on the part of partners, I have seen it all. However, with experienced brokers and risk consultants on board, this can usually be turned around.

Yes, a buyer's insurer will, of course, look at the claims record if it is poor, but this can sometimes be easily explained in a language they understand with appropriate risk and compliance measures put in place.

Conclusion: Price and Value.

It's important to note that these are general guidelines, and the actual valuation of a law firm can vary significantly based on its unique characteristics and the prevailing market conditions. Engaging a professional M&A broker or financial advisor with expertise in the legal sector can provide a more accurate and tailored valuation for a specific law firm in the UK.

Remember, of course, that value is not the same as a price!

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