

## Episode Summary

**Episode number:** 106  
**Episode name:** *The Valuation Game: How, Exactly, Should You Value a Law Firm?*  
**Guest(s):** Andrew Whittingham

**What area(s) of law does this episode consider?** Valuing law firms.

**Why is this topic relevant?** It's practically a meme about lawyers that many of us chose to go to law school out of a fear of numbers - or, at the very least, a general desire to avoid them. But the reality of legal practice means that numbers aren't ever really that far away.

A civil litigator might deal with costs on a daily basis. A transactional lawyer might deal with pricing. A criminal lawyer might deal with years and discounts, and a law firm partner might - for various reasons - stress about the monetary value of the firm they run.

Valuing legal practices is an essential topic for lawyers because it directly impacts the financial health and strategic decision-making of firms. Understanding how to determine the value of a legal practice is absolutely crucial for mergers, acquisitions, partner buy-ins, and even exit strategies - it's a topic that cuts to the heart of legal business.

**What are the main points?**

- In professional services, various transaction types occur. At the high end, prominent firms often involve partner buy-ins, while mergers are common among large practices.
- Law firms and professional practices typically have two methods for partner buy-ins, depending on the goodwill involved. Some practices, particularly in accounting, don't require payment to buy in. However, in many cases, transactions involve paying for a share of the practice's goodwill, making valuation critical.
- Professionals in fields like law, accounting, and consulting generate business because of their individual reputation, rather than the reputation of the firm they work for.
- This makes it challenging to separate the goodwill of the practice from the personal goodwill of the lawyer.
- EBITDA stands for *Earnings Before Interest, Tax, Depreciation and Amortisation*.
- EBITDA reveals the core profitability of a business, regardless of its funding methods. It accurately depicts the underlying financial performance, offering a clear understanding of the business's viability and success.
- Typically, an EBITDA multiple is used to evaluate most businesses, but law firms have a unique element of personal goodwill and different cost bases. Factors like high rental and staff costs in city-based law firms can affect profitability compared to regional firms which typically have lower expenses.

- Factors such as the financial health, growth trajectory, cost base, gross margin, profitability, and service lines of a practice influence a firm's EBITDA multiple.
- Complementary service lines, location, retention of key staff, and adoption of technology also impact the multiple. Higher synergy, metropolitan location, staff retention, and efficient technology usage lead to higher multiples.
- The traditional model for professional practices is the “*a third, a third, a third*” pricing model.
- However, this model is evolving, particularly in the legal industry, where staff costs have risen and remote or hybrid working arrangements have reduced the need for office space.
- In a professional practice, operational costs are a significant factor, with staff costs being particularly significant.
- WIP is an asset that needs to be considered when allocating working capital, as its recoverability varies based on the type of legal practice.
- There are multiple factors that determine the value of a business, beyond just profitability. Assessing the financial health alone overlooks other risks, such as employee and personal goodwill risks, as well as the absence of insurance coverage. These non-financial risks should be considered when determining the value of a business.
- AI adoption has increased, with various industries developing their own software. Also, in the post-COVID era, where online activities are prevalent, smaller law practices are outsourcing legal work abroad.
- Planning for exit from a business involves passing down relationships to junior practitioners to reduce dependence on the firm's partner. Outsourcing administrative tasks and delegating client work to enable the business owner to focus on managing and growing the firm.
- Debtors, including those over 90 days due, are generally less collectible compared to more current debtors. This implies that companies may face difficulties in recovering payment from long-standing debtors, impacting their overall financial situation.
- Long service leave, despite being a significant financial liability, is often overlooked on a firm's balance sheet. It is important to consider such benefits as they can impact a company's financial standing.
- When acquiring or selling a business, calculations based on working capital can significantly impact the purchase price, so understanding the normal working capital level in the business is crucial.
- Tracking recurring revenue is crucial for businesses, as it indicates stability and value.
- It is important to assess if there is a concentration risk with certain partners generating significant work from a few clients. Other factors to consider include

**What are the practical takeaways?**

employee retention, succession plans, services offered, and the use of technology and intellectual property to make the practice more efficient and competitive.

- A succession plan can often lead to a better financial outcome for law practices.
- When transitioning a practice, it is crucial that lawyers hand down responsibilities to new practitioners and understand the current state and future goals of the practice. Proper reporting that takes into account KPIs, new clients, partners, service offerings, client retention, and staff retention, is essential.
- Embracing new technologies like automation improves efficiency and allows staff to focus on providing valuable advice to clients.
- Understanding valuations of law practices is crucial for informed decision making in growing a practice. It helps identify potential risks such as personal goodwill, employee and customer retention, and customer concentration. Additionally, it facilitates understanding the strategic fit with different service offerings, partners, and firms.
- Legal practitioners should prioritise financial literacy to understand the inner workings of their own business, the key metrics to measure its performance, and its overall value. This knowledge empowers them to make informed decisions and effectively manage their practice.