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Valuation & Exit strategies for law firms

Presented by

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21 June 2018

Representing, promoting and supporting solicitors



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Howard Hackney

Howard escaped from Grant Thornton UK LLP in 2008 where he had been a partner for over 25 years to establish his own boutique practice. During his time at Grant Thornton he was head of professional practices for the North West and head of family businesses for the UK. At Grant Thornton he had a variety of roles including office Managing Partner, North West regional marketing partner and membership of the partners appointments panel. Howard specialises in advising mid market professional practices and family businesses. In 2002 he won the CBI's national award as "Best Business Adviser".

Howard's focus is providing "special projects" advice to firms with up to 20 partners. Recent assignments have included sales of law firms, partnership disputes, fund raising, LLP and ltd company conversion, ABS conversions, and capital structuring and profit sharing advice



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Mark Briegal

Mark Briegal is a partner at Aaron & Partners LLP, a specialist commercial law firm. He heads up the Professional Partnerships team which covers all aspects of professional partnership from formation to dissolution including disputes, mergers and acquisitions and regulatory matters. Mark mainly advises solicitors.

By way of background, Mark studied Classics at Cambridge University and graduated into the City, working in international banking and management consultancy before converting to law.

Mark helped to establish the North West branch of the Association of Partnership Practitioners.



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Agenda

- Strategic options
- Value of your firm
- Finding a buyer
- Alternatives
- Tax issues

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Options for the firm

- Bring in new partners
- Sell
- Close down
- Acquire/merge - is there ever a true merger
- Factors affecting decision to sell
 - Strategic position
 - Market conditions
 - Price



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Value of your firm



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What does 2+2 make?

- Ask an accountant - what do you want it to make?!
- “Art not a science”
- Worth what a buyer will pay
- Wide variations not unusual
- Different values for different purposes



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Background

- Different types of practice
- Methodologies
- Goodwill & contingent WIP
- Market conditions



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Different types of practice

- For this purpose:
 - Process driven, volume transactions
 - More traditional “collegiate” full service firm
- Profits less dependant on the skills of the staff and partners
- A goodwill driver



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Methodologies

- Net assets
- Earnings
- Suggest others are unreliable



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Net assets



- By far the easiest
- Adjust for market values
- Other liabilities e.g. PII run off, redundancy, close down
- Contingent WIP often not included
- Discounts will apply
 - Fixed assets 90%
 - Debtors perhaps 10% collection fee
- Goodwill - unlikely for a non specialist “collegiate”

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Contingent WIP

- Usually called goodwill as on sale may be taxed at 10%
- Time records usually unreliable
- Eliminate “dead” cases
- Number of cases X average value achieved % 50% (to represent ½ way through)
- Then apply a discount
- Role of specialist Valuer's

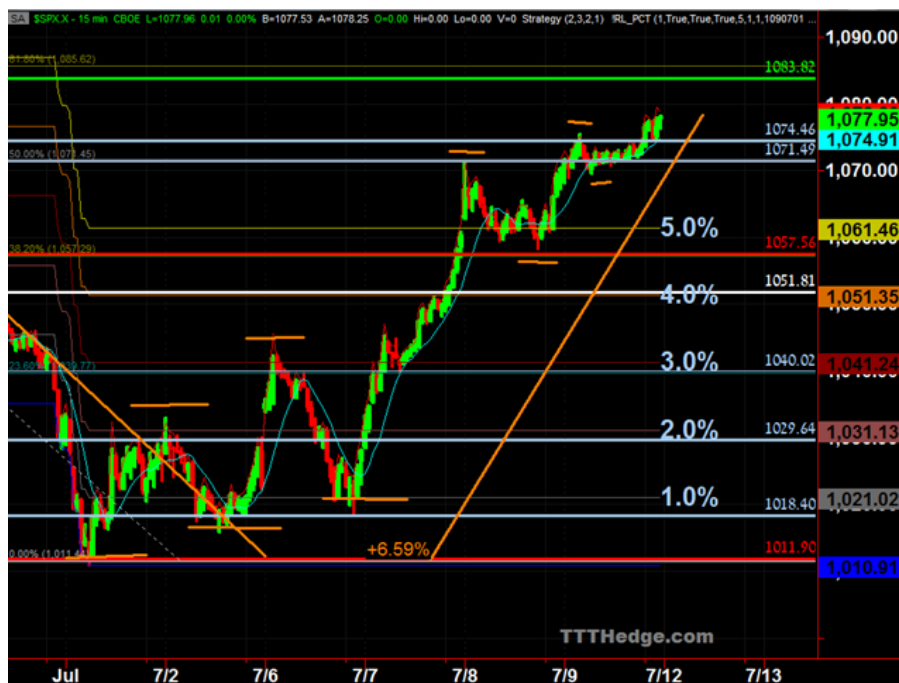


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Earnings basis

- Goodwill = value less net assets
- Maintainable profits X multiplier
- Variables
 - Maintainable profits
 - Exceptional items
 - Management reward
 - Weighting
 - Tax
 - Multiplier
- See template



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	2XX3	2XX2	2XX1
Profit for the year per the accounts	1,000,000	900,000	1,300,000
Adjust abnormal items			
Redundancy and reorganisation costs	100,000	400,000	0
Surplus on sale of assets	(200,000)	0	(50,000)
	900,000	1,300,000	1,250,000
Less commercial salaries for partners			
Partner 1	(100,000)	(100,000)	(100,000)
Partner 2	(50,000)	(50,000)	(50,000)
Partner 3	(75,000)	(75,000)	(75,000)
Partner 4	(75,000)	(75,000)	(75,000)
Normalised trading profit	600,000	1,000,000	950,000
Less tax at between 20% and 25%	(135,000)	(235,000)	(222,500)
	465,000	765,000	727,500
Weighting	3	2	1
	1,395,000	1,530,000	727,500
Weighted average maintainable profits		608,750	
Indicative values			
Using multiplier of 4		2,435,000	
Using multiplier of 8		4,870,000	
Using multiplier of 6		3,652,500	
Net assets		3,000,000	
Overall value		3,652,500	
Goodwill		652,500	

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What multiplier?

- THE most difficult
- Sector, size & economy
- BDO PCPI 10.3
- FTSE all share 12.6
- Smaller = bigger discount
- Rule of thumb 4-8



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Market conditions?

- Multiplier expected by HMRC approx 3 x pre tax profits or 80% to 100% of fee income = c. 4 x post tax profits
- CFA WIP
 - Realisations 35% to 75%
 - Upfront 60% best – most will not take the risk
- Debtors – usually on collections less 10% admin fee
- Fixed assets – 10% of book value
- Gateleys/GCL £4.2m (£2.3m cash - 3 years & £1.9m shares)
GCL turnover £6m & corporatised EBITDA £600k = 7X

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Finding a buyer (achieving best value)

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Creating a competitive market

- Price is only one element
- Is it a merger or sale? - understand negotiating position
- Use a lead adviser
- Six to nine months timescale
- Create a market - but??



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Role of the lead adviser

- Creates the market
- Critical friend
- Independent
- Market knowledge
- Pre sale preparation
- Expected value
- Confidentiality - approaches & process
- Play “hard ball”
- Ask the difficult questions of targets



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The stages

- Prepare Information Memorandum (IM)
- Identifying targets
- The process



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The IM



- A sales document
- “Paint the picture” with adjusted results
- MUST be available before going to market
- Aids assessment of market value
- Establishes negotiating strengths and weaknesses
- Second guess question from targets
- Do NOT indicate price
- Questions about the acquirers
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Identifying targets

- Confidentiality important - Blanket approach dangerous
- Use a “lead adviser”
- Jointly you will know the likely firms - only one needed
- Perhaps a dozen at first stage = 2 or 3 at final stage
- Criteria
 - Services
 - Geography
 - Financial strength



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The process - Stage 1 to indicative offers

- Initial confidential approach by lead adviser
- Taster - elicit interest & with process & timetable
- NDA - and informal agreement to limited circulation of IM
- Issue numbered hard copy of IM - not by email
- Meet targets - genuine two w
- Indicative offers
- Establish offeror's solvency
- Assessment of softer issues



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The process - Stage 2 to formal agreement



- Assess offers
- Clarify & negotiate (2 week window perhaps)
- Identify preferred party
- Non binding HoTs with binding exclusivity period
- Mutual DD - defined scope
- Final negotiation & formal agreement
- If more than 9 months probably “dead”

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Practical issues

- Consideration
 - Cash
 - Deferred - loan notes
 - Shares
 - Earn out - do not expect value
- Completion B/S - can be a big issue - often nil cash/debt
- Deal breakers - identify early & be unemotional
- DD - Will be used to “chip” the price often after HOT’s when committed - Understand & recognise the other side’s perspective



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Documentation

- It's simple isn't it!! - oh no it isn't
- SPA the basic document
- A “cast of thousands” if care not taken - Company, employment, property, IP AND from each side!
- Service agreement if continuing employment
- Loan note agreement
- Non compete covenants
- Share sale lock ins



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Alternatives

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Topics

- Capital structuring to bring in new partners
- Role of pensions

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Partner capital

- Separate profit sharing from capital ownership
- Need to distinguish between types
 - Fixed = ownership stake/share
 - Current
 - Tax provision - complex but highly recommended
- Current account to be freely withdrawable
 - So sufficient bank facilities needed
 - Fixed capital set sufficiently high
- Fixed capital often borrowed personally (off Balance Sheet)



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Value including WIP

Fixed assets	75,000	75,000
Current assets		
Contingent WIP	0	300,000
WIP	500,000	500,000
Accrued income	350,000	350,000
Debtors from clients	285,000	285,000
Disbursement debtors	75,000	75,000
	<u>1,210,000</u>	<u>1,510,000</u>
Current liabilities		
Trade creditors	10,000	10,000
Bank borrowing	500,000	500,000
	<u>510,000</u>	<u>510,000</u>
Net current assets	<u>700,000</u>	<u>1,000,000</u>
Net assets	<u>775,000</u>	<u>1,075,000</u>
Partner capital	<u>775,000</u>	<u>1,075,000</u>

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Points system – capital and “dividend”

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Alice Arnold	80	90	100	100	100
Brian Barlow	100	100	100	90	80
Cathy Clarke	60	70	80	90	100
David Dawes	80	90	100	100	100
Edward Eagle	80	70	60	50	0
	400	420	440	430	380

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Alice Arnold	20.0%	21.4%	22.7%	23.3%	26.3%
Brian Barlow	25.0%	23.8%	22.7%	20.9%	21.1%
Cathy Clarke	15.0%	16.7%	18.2%	20.9%	26.3%
David Dawes	20.0%	21.4%	22.7%	23.3%	26.3%
Edward Eagle	20.0%	16.7%	13.6%	11.6%	0.0%
	100.0%	100.0%	100.0%	100.0%	100.0%

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Alice Arnold	215	230	244	250	283
Brian Barlow	269	256	244	225	226
Cathy Clarke	161	179	195	225	283
David Dawes	215	230	244	250	283
Edward Eagle	215	179	147	125	0
	1,075	1,075	1,075	1,075	1,075

Pensions - A personal view



- Genuine self administered arrangements
- Benefits
 - Tax benefits - contributions, growth & IHT
 - Security for the individual - & usually safe from bankruptcy
 - Potential cash release of money in existing properties
- Restrictions
 - Lifetime limit £1m
 - Restricted contributions if income >£150k
 - 3 year carry forward relief - potential £160k
- Complex but worth it and take advice
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Commercial property

- Alignment of partners' & firm's interests
- Rental returns of 5%-10%
- Property purchased at 40%+ discount
- Open market rent to be paid – tax deductible & tax free
- For existing props. can release cash (watch CGT & SDLT)
- Can buy <100%
- Try to align ownership with points
- Need for agreement with partners on exit



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Funding parameters

Cost of property	<u><u>500</u></u>
Pension contribution Net	128
Tax refund	<u>32</u>
Gross contribution (over two tax years)	160
Existing fund transfer	<u>173</u>
Fund value	333
Borrow 50% of fund	<u>167</u>
Total funding	<u><u>500</u></u>
Further tax saving at say 20%	(32)
Initial contribution	<u>128</u>
Net cost of pension contribution	<u><u>96</u></u>



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Tax issues



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Tax

- Limited company
 - Can sell shares or assets
 - Buyer usually prefers assets and will usually pay more
 - Seller usually prefers shares and will usually accept less
- Self employed
 - Use overlap relief where accounts not to 31 March (or 5 April)
 - Manage payments on account for final and future years
 - Watch claw back of capital allowances if fixed assets sold



Tax

- Entrepreneurs relief (ER)
 - 10% upto £10m
 - One year ownership of at least 5%
 - Employee or owner
 - Sale of business (so just of property not eligible)
- Goodwill and CFA WIP called goodwill
 - ER available at 10%
 - Otherwise taxed as income
 - No tax relief to acquirer





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Thank you

Thank you for participating.

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