



TrendWatch 2005: A Look at Professional Service Firm Valuations

Professional service firms used to be “different.” Traditionally, they were run by the people with their names on the door. They often lacked the structured policies and procedures of other types of companies. They relied purely on their service expertise to distinguish themselves in the marketplace, with little advertising or marketing to help them along.

In the last few decades, even small professional service practices have started to look and act more like their corporate cousins, complete with marketing directors, human resources managers and thick policy manuals. These changes have also created changes in how professional service firms are valued. As professional service firms have become more sophisticated, the art and science of valuing them has become more sophisticated as well.

Who’s “Professional”?

Professional practices are typically service-driven. Their primary assets revolve around people instead of products. Most professional services require specific education, and many require a license to practice. They have traditionally been defined as services performed in the fields of accounting, actuarial science, architecture, consulting, engineering, healthcare, law and performing arts.

But many other types of services can also be considered professional services, from private investigators to clinical social workers to patent agents and court reporters. Often these businesses rely on referrals and reputation as a key

means of generating business. For this reason, goodwill is extremely important in the valuation computation. (See sidebar.)

Specialization Impacts Value

Like other companies, professional service firms are becoming more specialized. They're engaged in a different mix of work than they used to be, and they're more reliant on the specific talents of key employees. What does this do to corporate value?

Service Mix — As they become more specialized, many firms are doing more project-based consulting work and less ongoing retainer-based work. This is especially true in the fields of law and accounting. Project work is generally less stable and predictable than recurring work from long-term clients. As the percentage of “non-annuity” work increases, value generally decreases.

Customer Dependency — Ultra-specialized firms typically have less market opportunity than generalists. As firms become more reliant on fewer clients, risk regarding ongoing income increases and value decreases.

Key Talent Dependency — If a firm depends on the specialized expertise of a few key employees, what happens if they leave? This dependency leads professional service firms to try to lock-in talent with better pay, richer benefits and stricter non-compete clauses in employment agreements. The more secure the talent, the higher the value of the company.

The nature of professional service firms has changed dramatically — and so has the expertise required to assess their value in today's marketplace. Look for a business valuation partner who is highly experienced in professional service firm valuation and is current on specific industry trends.

Interested in discussing a professional service firm valuation for the purpose of a purchase or sale or marital dissolution? Let us tell you how our firm can help.

A Word About Goodwill

In professional service firms, goodwill is key. Firm value is highly impacted by the people involved. Their personal intellect, talent and connections are often the factors that make the firm successful. In today's age of professional branding and public relations, certain individuals — even in small companies — can have super-high profiles.

Determining the amount of personal versus company goodwill is an intricate operation, particularly because each state has specific rules about how it recognizes personal goodwill with regards to marital assets.