How to Value a Law Firm: Key Insights and the Rule of Thumb

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The valuation process for any type of business can be daunting, but law firms pose unique challenges. Nonetheless, you will need to understand law firm valuation if you want to sell your practice, or if you want to acquire another firm.

Here we review some of the basics of how to value a law firm, such as different approaches and the law firm valuation rule of thumb. Mastering these essentials willl position you to gain the best value out of your law firm sale or acquisition.

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What is law firm valuation?

Law firm valuation is the process of establishing the fair market value of a legal practice. It comes down to setting a reasonable price for a law firm that you are seeking to buy or sell. There are different valuation approaches for law firms, some of which are the same as common valuation methods for other types of businesses, and others that are unique to the legal industry.

Why is law firm valuation important?

Law firm valuation is important for putting yourself in a good bargaining position when you buy or sell a practice. For sellers looking to retire from the practice of law, the valuation process will likely be an integral part of their retirement planning. It can also be integral to succession planning.

Even in cases where a firm is not being sold or acquired, valuation could still be critical. You may need to determine the practice's value to secure loan financing, for example. Or, a new partner joining the firm may need this information for the purpose of buying into the practice.

It is also vital to remember that any of these scenarios could arise at unexpected times. The COVID pandemic provides us with a recent example of how circumstances affecting a firm's fortunes can arise quickly and seemingly out of nowhere. Accordingly, valuing your law firm may be necessary even if you are not contemplating a sale any time soon.

Five law firm valuation methods

To start the valuation process, you must recognize that you will most likely need professional assistance. Valuation of law firms can be complex and very different from other types of business valuations.

There are several types of valuation approaches for legal practices, with the five most common methods listed below.

1. Revenue-based approach and the rule of thumb

The revenue-based approach takes the firm's annual gross revenue and multiplies it by a certain number, known as the multiplier, chosen based on the firm's projected ability to maintain or increase those revenues in the future. This is also known as the law firm valuation rule of thumb. The multiplier tends to be in the range of 0.5 to 3.0, with wide variations based on various factors. The rule of thumb is discussed in more detail below.

2. Discounted cash flow

Unlike the rule of thumb method, which is based on past performance, the discounted cash flow approach is based on future performance. Using the firm's estimated future cash flows and an expected rate of return for a buyer, you determine the terminal value after a set period of time. Then this value and the cash flows are discounted to their present value.

This valuation method is often considered superior to an approach based on past revenues, since it is forward-looking. One disadvantage is that the future projections could be inaccurate. In addition, it will miss important factors for some law firms, such as unique practice areas or client bases.

3. Market comparison approach

This method involves researching recent sales of firms comparable to yours—or the one you are seeking to acquire—and using that information to determine fair market value. This is similar to the use of "comps" in real estate transactions.

One glaring drawback of this approach is that information on law firm sales is often confidential and not publicly available. In addition, it can be difficult to find a "comparable" firm when each legal practice has so many unique characteristics. Nonetheless, this information (if available) can be used in conjunction with other methods to help determine a fair value.

4. Using multiple methods of valuation

There is no rule mandating that a singular method of law firm valuation must be chosen. Instead, multiple methods of valuation could be used to find a practice's value. Every practice is unique, which means different methods could be assigned different weighting depending on the firm's distinctive characteristics.

5. Asset-based approach

An asset-based approach is based on the firm's assets and liabilities. After calculating the total value of the firm's assets, subtract the firm's liabilities to yield a net value. The firm's assets include tangible items, such as property holdings and office furniture, and intangible assets, such as goodwill and the firm's existing client base.

Assets – Liabilities = Net Value

Tip: While the asset-based valuation method has the advantage of simplicity, it is *not* favored for legal practices. Cash flow and earnings are generally considered most important to determine a firm's financial health. The asset-based approach does not take either of these into consideration, making other valuation methods preferable.

Is it common to use multiple valuation methods for a law firm?

Yes, it is common to use multiple law firm valuation methods, as each valuation method has its advantages and drawbacks and it is wise to consider a variety of factors.

The rule of thumb in law firm valuation

The rule of thumb method for law firm valuation is based on the firm's annual gross revenue multiplied by a chosen factor. The commonly used multiplier in the legal field is in the range of 0.5 to 3.0, but some valuation experts recommend a narrower range. Often the annual gross revenue is averaged over several years, with a five-year time period being common.

The multiplier is chosen based on the firm's projected ability to maintain or increase those revenues in the future. This can be judged by factors such as the firm's:

1. Practice area
2. Geographic location
3. Number of clients

It is also important to assess the amount of repeat business from clients and the transferability of those clients to a new owner. A firm whose reputation overly depends on the personal reputation of the previous owner may receive a lower multiplier.

The rule of thumb method has the advantage of being relatively straightforward and an excellent starting point. The difficulty comes in selecting law firm valuation multipliers, as every firm's situation is so unique.

In addition, a law firm's revenue in past years may not be a good indicator of value, especially where there is good reason to believe revenues will drastically increase or decrease in future years.

Rule of thumb method calculation example:

Let's say a law firm has an annual gross revenue of $1 million over the last five years. To use the rule of thumb method, we would take this average annual revenue and multiply it by a valuation multiplier, typically between 0.5 and 3.0.

Low-End Valuation:

Multiplier: 0.5

Valuation = $1 million * 0.5 = $500,000

High-End Valuation:

Multiplier: 3.0

Valuation = $1 million * 3.0 = $3 million

This gives the law firm a valuation range of $500,000 to $3 million based on the rule of thumb method.

The multiplier is derived from industry norms, market conditions, and firm-specific factors like profitability, client base, reputation, and growth potential. For law firms, multipliers often range between 0.5 to 3.0 because:

- Smaller or less profitable firms may warrant a lower multiplier.
- Larger, more profitable, or niche-specialized firms may justify higher multipliers.

Top factors affecting the valuations of law firms

A wide variety of factors affect how you will ultimately determine the value of your law firm.

1. Financial health of the firm

One obvious factor affecting a given law firm's valuation is the financial health and success of the law firm. Accordingly, total revenue and profits are key considerations, as well as growth in those areas. In addition, how large is the firm's client base? How in-demand are its practice areas?

Also, look at other prospects for the firm's future. This includes an analysis of the firm's competitors in the same practice areas. Multiple revenue streams can also help a firm weather rough patches and increase market share down the line.

2. Goodwill

Goodwill in business accounting refers to the portion of a business's value above and beyond the asset-based calculation of 'assets minus liabilities.' For law firms, it generally refers to the practice's brand and reputation.

While difficult to measure, it is critical for law firm valuation—especially since the asset-based approach is so inadequate.

It is important to distinguish between practice goodwill and personal goodwill.

- Personal goodwill = applies to individual lawyers
- Practice goodwill = extends to the firm as a whole

If the firm's success depends on the personal goodwill of the lawyer selling the firm, then the firm will be worth less once that lawyer is gone. This means practice goodwill is more important for valuation.

3. Overcoming valuation challenges

There are common challenges in law firm valuation that you must anticipate and overcome. There is inherent subjectivity in valuing intangible assets, such as goodwill. Evaluating future earning potential will also require some degree of speculation.

The best way of overcoming these challenges is to get expert assistance and obtain a detailed analysis of these factors, using the financial data your firm already has.

Maximizing law firm value

Another great way to maximize the value of your law firm is to securely store all of your case files in a cloud-based case management solution—this will greatly aid you in selling your firm for an easier transfer of power, reducing the risks of case or client details getting lost or mishandled during transitional periods.

An organized firm with a solid tech stack for efficiency, productivity, and overall organization will likely be worth more than a paper-based practice in the eyes of a purchaser. This also shows that you are willing to do all that you can to increase your firm's profitability and efficiency while building a strong client base.

And of course, always ensure that your firm has an abundance of practice goodwill, as opposed to personal goodwill that extends only to you or other individual attorneys at your firm. Once you determine the current status of all the factors discussed above that help determine your firm's value, you can work on those factors that need improvement.

Final thoughts on law firm valuation

Law firm valuation is an essential task in private practice. This is true not only at the time of buying or selling a practice, but any time you need to capitalize on your firm's value and also maximize it. Follow these guidelines to stay on the right track.

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Frequently asked questions

What is the rule of thumb in valuation?

The rule of thumb for law firm valuation determines the firm value by multiplying the firm's annual gross revenue by a chosen multiplier, often in a range of 0.5-3.0 for the legal industry. The annual gross revenue is usually averaged over several years, such as a 5-year time period.

What is the best formula for law firm valuation?

There is little consensus on the best formula for law firm valuation, as this will differ from firm to firm and multiple methods are often employed. The asset-based approach is disfavored for legal practices, but the rule of thumb approach, discounted cash flow method, and market comparison method all have potential benefits.

Is the rule of thumb method accurate for law firm valuation?

The accuracy of the rule of thumb method is difficult to gauge, since any valuation approach will be somewhat subjective. Nonetheless, if the firm's past annual revenues are expected to remain consistent in the future, it could be an effective valuation method as long as a reasonable multiplier is chosen.

What are the limitations of using gross revenue to value a law firm?

When using gross revenue for law firm valuation, it can be difficult to predict how gross revenues will change in the future. In addition, the correct multiplier—applied to the gross revenue to determine value—is not easy to determine.

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