Covid-19
And
Valuations Of Accounting Firms

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Content

Your Accounting Practice and Covid-19

Will this impact Accounting Firms?

Accounting firms are an important service in these times, and demand for their services will increase. It is simple to understand because your clients need you to apply for a loan or any of the incentives. The reality is, however, that large segments of your clients will be in serious trouble. The effects of COVID-19 will manifest in a huge increase in debtor-days and unpaid bills, business closures and unprecedented unemployment affecting a lot of your clients. This, unfortunately, will spill over onto you like a tsunami, something we have little control over.

Accounting firms must be measured through an appropriate assessment of your client base. You must be reviewing not only your own business but those of your clients. If you won't make it going forward, you must be engaging professionals to assist in getting a valuation of your business and planning for either selling it, merging with someone or buying more clients.

Impact on existing deals can already be seen. Many pending transactions are stalled in their tracks, with the parties trying to understand the landscape before proceeding, and efforts toward new deals have been frozen in time. Only after five weeks of lockdown are people starting to consider proceeding with deals.

It will be critical for companies to develop robust, defensible and up-to-date cash flow projections to confidently communicate the expected impact on their business in the current environment.

While the situation concerning COVID-19 continues to evolve, the effect on businesses and therefore, the flow-on impact on business valuations is significant.

The Impact On Your Accounting Practice's Value

The Impact On Accounting Firm Valuations?

As always, sentiment from buyers drives the perceived Value of your firm. In discussion with various regular buyers during the last week, the sentiment is that a lot of people do believe a lot of firms will be in the market and prices should drop as a result. The reality is that there is indeed blood in the water, the argument holds water, but not in all cases. We will get back to that, but let's look at sentiment first and these are the factors driving it and are just a few of the reasons why the Value of Accounting Firms may have declined due to COVID-19:

- Actual and expected revenues and earnings would decrease due to forced COVID-19-related closures or decreases in customer/client demand.
- Interest-bearing debt may have increased to pay employees and other fixed continuing expenses in most of the firms.
- Significant reduction in profitability as your fee base shrinks, but costs are static, and retrenchment of staff cost a bundle.
- Discount for lack of marketability may have increased due to liquidity issues in the Market, not only reducing buyers but also the terms they can offer.

Time will tell what the total impact of the pandemic will be on transaction volume. What we do know is this. Once discussions resume, valuations will need to rely heavily on professional judgment and industry specialisation to assist clients in assessing value. A few key considerations will be discussed, and they will include:

- **Cash Flow Projections**
- **Discount Rates**
- **Discount for Lack of Marketability**
- **Comparable Transaction Multiples**
- **Demands In Tiers**
- **Deal Structure**
- **Risk Mitigation**

Given the uncertainty concerning the duration and severity of COVID-19 and its related economic impacts not only on you but on your client base, we will need to employ even more careful considerations and judgment preparing realistic market valuations.

The Impact On Your Client Base

Any Accounting Practice is a sum of its client base

Any accounting practice is a sum of its client base, with the tweaking of processes and systems to unlock maximum value from that client base. Some are low-risk statutory work in the cloud with monthly debit orders while others are riskier once-off work, paid matter after the fact from the free cash flow of the business. Add to that a spread in high and low-risk industries and a picture starts unfolding where you are at, as a firm.

The direct and indirect impacts of the pandemic will likely place any SME under pressure. To assess your client base, you will have to consider these facts and circumstances:

- Which sector and industry do the clients operate in, and what are their specific lines of business?
- Where geographically are the entity’s operations concentrated?
- How will the business continue to deliver its products and services in the face of operational disruption?
- How long is operational disruption expected to last?
- How concentrated or diversified is the clients’ customer base, and which customers may be in distress?
- How concentrated or diversified is the vendor/supplier pool, and which vendors/suppliers may be in distress?
- Will the entity need to manage cash balances differently or modify its policies around working capital?
- Will capital expenditures need to be deferred (to conserve cash) or potentially accelerated?
- What actions must the business take to maintain compliance with debt as set out in the new world opening up?
- Has the SME applied for or received government assistance under the measures offered?
- Was the client highly leveraged prior to the COVID-19 crisis?

The impact on your client base will be fundamental to the value of your firm. The risk will be discounted into the price and the deal structure. Any Due Diligence will now put as much effort into this as into any other part of your business. Any offer made will try and mitigate this risk as far as possible.

The bottom line, you need to know and understand your clients if you want to have the real value of your firm determined. Valuation specialists commonly look to the Discounted Cash Flow (DCF) Method when estimating the value. This will carry more weight than in the past, and unless you can ensure the Future Cast Flows, Discount Rate and Long-Term Growth is justified your firms’ value will be severely impacted.

The Impact On Deal Activity

Deal Activity Impact the Lack of Marketability

Whether to engage in a transaction now or consider alternatives such as hanging onto your cash is a big decision for many a buyer during the pandemic. The main reason is that nobody knows for sure how this will impact the market and play out. What we do know is that there will be an increase in certain types of transactions. These include deals to strengthen income and limit costs, address liquidity constraints or pursue acquisitions or mergers and people exiting the market.

Because of the significant economic disruption caused by the COVID-19 pandemic, some will have no choice and be forced to enter into transactions to salvage what is left from what they had.

However, the question is, what is deal activity and the impact thereupon right now?

- **For deals implemented and concluded,** but not fully paid, buyers are in some instances trying to renegotiate terms. This concession, however, comes at a price as they seek a solution from the seller.

- **For deals done,** but not implemented, the parties in some instances slammed on the brakes. Those with the cash hang onto it, those with solid businesses are not so sure they want to form part of something new, where they dont understand the Covid-19 resilience. It is mostly a wait-and-see approach, which obviously will have Covid-19 resilience on the Agenda when we proceed.

  - ➢ Those moving forward:
    - ✓ involve strategic buyers expanding their fee base or geographic footprint;
    - ✓ address a mission-critical need or offer significant synergies; are capable of being completed with little or no debt financing, practice seller typically provides vendor financing;
    - ✓ the deal structure already has a risk mechanism in place to cater for a drop-off in fees;
    - ✓ the buyer is one of those retrenched and needs to ensure an income;

- **For deals signed**, buyers are generally waiting out the current uncertainty, with a handful of exceptions that are pushing ahead to secure the benefit in uncertain times. In these instances, the deal structure already has a risk mechanism in place.

- **For deals in the market**, it is a mixed bag. Some are taking a wait-and-see approach, and others are moving forward, but the process timing is being extended. Most buyers prefer in-person management meetings, so despite all the Video Conference calls, some still want to meet in person. The current travel restrictions have created difficulties.

Adjustments to financial performance for COVID-19 will become part of the discussion in every deal.

What is, however very important to understand is that demand still by far exceed availability and will increase as more people will need to increase their fee base just to survive going forward.

Key Consideration For Covid-19

Considerations Impaction For Your Accounting Practice Valuation

These key considerations will impact the valuations going forward.

Cash Flow Projections

A lot of thinking must now be applied to the risks associated with the cash flow of a particular business and the elements that are factored in the discount rate, as well as the risks involved in realising the cash flows at the date of the valuation. For instance, the “risk-free” rate is now not entirely “risk-free” and the unsystematic risk should now capture extra risks in light of COVID-19.

There is a fundamental understanding that a valuation is forward-looking and cash flow projections reflect what is “known or knowable” at the time of the Valuation. The change that is occurring around the world is material and rapid. Therefore, the valuation of an entity as of 31 December 2019, will look dramatically different than the valuation of the same entity as of 1st May 2020.

Additionally, 2020 revenue and expenses will assuredly reflect significant fluctuations from historical trends and will not reflect a normalised level of operations for the basis of forecasting a business’s cash flow. Therefore, we will have to be acutely aware of the need to make normalising adjustments to both revenue and expenses as part of the Cash Flow forecast models well after the pandemic stops. Furthermore, there is significant uncertainty surrounding how long the pandemic will continue, meaning the development of cash flow projections will require substantial judgment based on the facts known at the time of the valuation.

The increased uncertainty, and risk associated with the cash flow projections, will need to be accounted for within the selected discount rate used within the valuation.

A key consideration in valuing companies will be assessing the impact of COVID-19 on near-term and longer-term financial projections that may not yet be known or quantifiable and/or likely will be subject to change.

Discount Rates

The selection of a discount rate is meant to align the relative risk associated with a firm, compared to alternative investment options and their associated rates of return. Suddenly we find both of these in flux.

In times of crisis, and with extraordinary market volatility, it becomes paramount for us to view market data through a different lens. Therefore a mechanical discount rate without understanding and being consciously aware of the data and assumptions relied-upon is extremely dangerous. Monkey see monkey do, won’t work in preparing a valuation with incorrect Discount Rates.

The discount rate selected must match the inherent risk of achieving the cash flow projection of the subject entity. The discount rate must also be derived based on what is "known or knowable" as of the valuation date and the industry and the market. Specialist knowledge is now needed.

Discount for Lack of Marketability

The typical definition of marketability is "the ability to quickly convert property to cash at minimal cost with a high degree of certainty of realising the anticipated amount of proceeds."

The International Glossary of Business Valuation Terms defines a discount for lack of marketability (DLOM) as "an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability."

As within the last several weeks, there has been a marked increase in both price volatility and uncertainty surrounding continued business operations, it would be expected that the DLOM applied would be increased, likely materially, to reflect these conditions.

We will also bring this factor in for each accounting firm we value, and this is the most significant change. In the past, our discount for lack of marketability was purely based on demand as we experience in the market, with buyers for the firms influenced by size and geographical mix. We always had client mix as well, but this will cleary now have a much higher impact and weight in any valuation.

Comparable Transaction Multiples

Under the Market Approach, care will be taken, both now and in the future, when relying-upon reported and calculated multiples of firms sold. We have the most comprehensive database of this nature in South Africa, but this data must now be assessed with the new impact that Covid 19 brings. A multiple reported even a month ago could materially misrepresent the risk associated with a comparable transaction today.

Further, as we move past the current pandemic, we shall consider carefully the use of multiples associated with transactions that occurred both during and in the wake of this global crisis.

Each valuation, therefore, requires more care and understanding of the factors at play.

Demands In Tiers

In the past, our discount for marketability was purely based on demand as we experience it in the market, with buyers for the firms influenced by size and geographical mix. We always had client mix as well, but this will cleary now have a much higher impact and weight in any valuation. Therefore the demand in Tiers will be adjusted, but a whole bunch of entrants that are retrenched will skew this in the next 18 months.

Deal Structure

The Deal Structure will have to reflect what people can afford, both from current cash shortages to the ongoing availability to keep up with payments. This pressure on cash will remain for a significant while. All valuations, therefore, will need to take the new normal into consideration, and not only will deposits be lower, but terms will be longer.

Deal structure will, therefore, hinge as before on cash availability one end and as before on risk mitigation on the other end.

Risk Mitigation

Historically accounting firms transactions and valuations were based on a deposit and the balance after 12 month period, subject to a Turnover Warranty. This will still very much be the case for valuations, but lower deposits and longer warranties will also be required now. The aspect that was never part of this was the payment profile of debtors, although that was always assessed during Due Diligence and impacted the transaction if not up to standard. We see that this will now have a material effect not only on the purchase decision, deal structure or a debtor warranty like we had in the past, but will also will become a significant factor on valuations going forward.

Final Thoughts

Considerations Impaction For Your Accounting Practice Valuation

This is an extraordinary time for the world, our country, and the accounting industry. While the full impact of COVID-19 is unknown and uncertain, what is certain is the need for accountants to be vigilant and informed and to be flexible and adaptable in their response to these changing times. Taking the necessary steps to either exit the industry if you were hanging on up to now is important, or all may be lost, whereas on the other hand, this is the time if you plan to expand to acquire a fee block, the caveat is not to pay a lower price as demand will drive the price, but having the right risk mitigation criteria and deal structure protecting you from the unknown.

Our valuations will provide as far as possible for the factors and proposed deal structures. This may be in the form of lower deposits, longer repayments coupled to cashflow and the standard warranties we normally imbed. These warranties however more than likely will be for longer than the standard 12-month period to coincide with the pandemic duration and will help to provide protection from potential losses that may arise as the public health and economies recover.

About The Author

Africa's Leader In Accounting Practice Sales

Louis has 30 years of solid business experience in various industries ranging from small businesses to large corporates. Louis has also owned and successfully operated various businesses with business partners and shareholders in the SA, UK, USA, New Zealand and Australia. He understands both corporate operations and small entrepreneurs and the differences. He understands the need and expectation of buyers and sellers in various industries, including the accounting profession alike. He is highly regarded by Sellers to find the best-qualified Buyers and in completing sales transactions professionally and in the timeframe required by the Seller and Buyer.

Louis is co-owner of Aldes Orion, part of the prestigious Aldes Group with 40 Franchises. Aldes have been selling medium and small businesses since 1979. Aldes Orion, a franchise of the Aldes Group, has since inception in 2009 won multiple awards and is consistently in the top 5 franchises of Aldes. Aldes Orion sold 22.3% of all businesses sold by Aldes in 2017. In 2018 and 2019 we once again received the Most Deals Award and also Sustained Excellence. Louis was also the Top Broker of 2017 and 2019. Louis began facilitating successful accounting practice transitions in 2009.

Louis has personally sold more **accounting practices** in South Africa than any other broker in the last ten years. In the previous 36 months alone, he has facilitated the sale of over 60 accounting and auditing practices ranging from R200,000 to more than R20 Million, including financed transactions. He is arguably the leader in Accounting and Audit Practice Sales in the country.

We perform valuations, sell and consult to small single practitioner Bookkeeping Practices through midsize, ACCA, SAIBA, SAIPA, SAICA and IRBA practices to larger firms over R200m. We also assist in mergers and buy-outs for our extensive database of accounting practice clients, many are repeat buyers, and we remain in touch with those buyers enabling us to understand industry sentiment.

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