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# Transaction Issues in Engineering and Consultancy Firms

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*No consultancy firm is directly comparable with another. The analysis of a consultancy firm should consider the different segments of the business and each segments "sustainable" earnings and working capital requirements.*

In the current market we are seeing consultancy firms dealing with succession issues as partners look to retire. One of the strategies adopted is through the aggregation of consultancy firms.

Sales, mergers and acquisitions of this type can also provide greater scale and economy to service existing clients and provide smaller firms the ability to get funding for working capital.

Any proposed transaction of a consultancy firm or valuation needs to consider the following key areas:

## 1. Value & Goodwill

It is important to understand that the value of any asset, consultancy firm or otherwise, is a function of its future free cash flows and the risk of achieving those cash flows. This is demonstrated by the capitalisation of future maintainable profits (FMP) method. This method is the most commonly used in commerce today.

Items to be considered in applying this methodology:

- full understanding of the business
- special risk particular to the target firm
  - client composition and relationships
  - growth prospects
  - staff loyalty and retention
  - culture
  - level of debt and commitments (incl premises leases)
- calculation of FMP before commercial salaries
- working capital and funding
- fixed asset costs
- competitive restraints

As discussed below another important factor in determining the value using the capitalisation of FMP is appropriate commercial salaries for the partners that will be continuing in the business.

Once the value of the partnership is calculated on a going concern basis it is also imperative to understand the structure of the proposed transaction and the assets and liabilities that are being transferred to the merged entity or retained by the divesting partners.

When considering the value of a professional firm it is critical to consider whether the goodwill is largely "personal" (specific to a partners expertise or reputation) or "commercial" (attributable to the overall firm). Personal goodwill follows the partner and any changes to this can dilute the goodwill attached to the professional firm.

## 2. Future Remuneration

The way partners are to be remunerated in the future is critical to determining if the proposed transaction meets all of the objectives in terms of:

- commercial salary and personal earnings requirements;
- ability to participate in profits; and
- ability to address succession

The composition of the above is **not** mutually exclusive from the valuation considerations and must be considered together.

## 3. Working Capital

Typically working capital of a professional services firm includes Work in Progress (WIP) and Debtors, together known as "lock up".

*Work in Progress* represents:

- work completed but not yet billed;
- work which has begun but not yet completed; and
- expenses incurred that are recoverable from clients.

*Debtors* represents amounts that have been billed to clients but are yet to be collected.

A review of WIP and debtors should consider what will actually be recovered in terms of cash. Some firms may carry significant WIP and debtor balances and only look at recoverability at year end. It is important to ensure that the balances transferred as part of the transaction are recoverable.

Any historical issues with recoverability may indicate issues with internal recovery processes as well as highlight issues with specific clients.

Trends, issues and movements in lock up can have material impacts on the funding requirements of the business going forward and can place pressure on working capital which the acquirer or merged group will need to fund.

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