Accounting Today for the WebCPA

# M&A in 2015

## Our annual roundtable of experts looks at the M&A landscape in accounting

01/01/2015

With a big firm merger being trumpeted seemingly every minute, it can be easy to miss the more subtle signals of change going on in the M&A market, as the expectations and demands of both buyers and sellers change over time.

To keep up with the shifting tides in the market, we convened a virtual roundtable of some of the biggest advisors and consultants in the field - who between them are responsible for arranging, facilitating or otherwise advising on billions of dollars of M&A activity in accounting - to share their thoughts.

Our four experts are: Steven Berger, a shareholder at law firm Vedder Price; Allan Koltin, CEO of Koltin Consulting Group; Jay Nisberg, founder of Nisberg & Associates; and Joel Sinkin, president of Transition Advisors.

### Is it a buyer's market, or a seller's?

Berger: It's difficult to make such a generalization because there are so many variables that affect whether buyers or sellers can assert more powerful positions in a negotiation. Factors such as the type of practice, the geographic market covered by the practice, whether the professionals are coming with the practice, the concentration of types of clients in an area, or the degree to which a practice is technologically advanced all affect the attractiveness of a practice. For example, in one geographic market, the demand may be saturated for audit practices, while tax practices could be in great demand. Though the importance of geography has been lessened with technology and mobile communications, it is not a factor that can be completely discounted.

Sinkin: The market -- whether you're a buyer or seller -- is heavily influenced by location and size. For small firms rooted in densely populated areas of the country, it remains a seller's marketplace. This is due in part to the fact that there are many large practices that can absorb a smaller firm with little to no incremental increases in overhead. However, if you are in an area with a sparse population of accounting firms, it's a buyer's marketplace because the size of the buyer audience is now much smaller.

Nisberg: It is definitely a seller's market. I have been involved in numerous deals in 2014 and it is not terribly difficult to find several interested parties as buyers. Of course, there are many discriminators, such as who has cash and who will only do a non-cash deal, but it is definitely easier finding buyers to introduce sellers to.

Koltin: I receive this question all the time and I have a simple two-word answer to it: "It depends." High-performing firms, whether they are buyers or sellers, continue to command premiums either in what they receive or what they offer. Obviously, a seller that has a demonstrated record of great growth and profits, and a deep bench, will command a premium; whereas a seller that has little to no growth and low profitability, with aging partners, will trade at the lower end of the spectrum. The same can be said for buyers. Buyers that can show a track record of great growth and profitability and have an exciting vision and opportunity for the future will typically offer a bit less (per se), simply because of the wonderful benefits, increased compensation and great retirement program that will accrue to the seller once they become part of the acquiring firm.

Berger: A practice top-heavy with partners and older accountants may be in less demand than a practice with a younger demographic profile. Or it could be the reverse, depending upon what the buyer's needs are. If a buyer is seeking a long list of clients from partners about to retire or experienced personnel to grow an existing practice, the buyer will evaluate potential targets differently. If I had to classify the market in one way, I would say it is still a seller's market. Firms seeking to expand understand that organic growth is much slower than growth by acquisition.

Sinkin: The biggest change in the buyer-seller marketplace lies among the small regional firms. When you are, for example, generating $6 million in revenues, few, if any firms can absorb you without significant overhead additions and expense. Also, as firms grow in size and seek to merge into a larger firm, again the pool of buyers is far more limited. For example, how many independent firms across the country are big enough and have enough excess capacity to take on a large firm? The supply of firms large enough to absorb firms generating, for example, between $3 million and $8 million is far less than the amount of such firms; thus, for firms in that range, it has started to become a buyer's marketplace.

## Can firms rely on selling their practice or being acquired as part of their succession/retirement plan?

Koltin: Nothing is certain when it comes to the sale of one's practice (assuming we're not talking about a fire sale!) I was recently working with a firm in which the managing partner (who was also a significant partner in the firm) suddenly passed away and the prospective buyers got cold feet. I've also worked this year with a firm in a geography where there were two significant and competing firms. To the dismay of one of the firms who passed on the opportunity to sell, lo and behold their competitor stepped forward and went with the acquiring firm. This has left the firm that chose to remain independent with limited succession opportunities for the sale of their firm.

Nisberg: The too-often-used answer "It depends" applies here. Not every practice has a buyer. The nature of the practice and demographics plays a large part in the ability to sell as a succession plan. Some ingredients include size of practice, nature of clients, age of partners, profitability and, of course, culture and values. Seller expectations also determine the viability of selling as a succession plan. I meet many sellers with unreasonable expectations on such factors as value of the practice, compensation of partners going forward and the scope of work required by an acquiring firm. The variables are many.

Berger: It has been said that a firm without an adequate succession plan is a firm that has a de facto merger plan. A merger or sale should not be viewed as a reliable succession plan because there are so many issues that can arise that will place that strategy beyond the bounds of reasonable commercial terms. If a firm's retirement plan is so rich for the more senior partners, the younger partners will be disincentivized from growing the practice for themselves, as that type of plan means the practice will never be theirs. Senior partners should review their succession plans, which generally means reviewing their partnership or other operating agreements, reviewing the demographics of the next leaders of the firm, and taking a realistic view as to whether the clients will remain with the firm after they retire.

What does it mean to sell the practice as part of a succession/retirement plan? The retiring partner is looking for someone (whether the next generation or an outside third party) to purchase the goodwill in the practice and to guarantee a retirement package. This is not so easy to achieve. The "goodwill" that the retiring partner is seeking to sell is not "goodwill" in the balance sheet sense of the word. Rather, it means the reputation of the accountant and the relationship that accountant has with his or her clients that can be sustained even if the senior partner has retired. If those client relationships are not transferable to a third party because the clients will not be willing to continue with the buying firm, then the value of the retiring partner's practice is minimized. Therefore, the retiring partner cannot assume that an outside third party will be able to successfully take over the practice. So, this leads to transactions highly dependent upon both the retiring partner's continued involvement in providing services on a limited basis and completing the transition. It also makes the dollar value of the retirement package to the retiring partner dependent upon the successful transition of clients.

Sinkin: If you are in a part of the country that is home to many local CPA firms, for example, New York City and the surrounding areas, the answer is "Yes," particularly for small firms, as well as those larger firms who are proactive with regard to succession and operate an attractive practice with good metrics. Firms that have weak metrics, poor staff and other less-desirable attributes will face a tougher challenge if M&A is key to their succession strategy.

Berger: Timing is key. A firm relying on selling its practice, rather than implementing a succession plan, cannot necessarily predict when a transaction will take place. If it is a seller's market at the time the firm wants to transition, then a transaction can be done to fit that schedule. But a firm cannot always assume that timing, the consideration to be received and other elements of a transaction will all line up simultaneously to satisfy the seller's needs and desires. So, one element may be sacrificed to achieve the desired timing.

### If that is part of their plan, what do they need to do to make it work?

Sinkin: Start the process as soon as possible. Ideally it should begin five to seven years out. The aging of the Baby Boomers means the marketplace is changing as the amount of practitioners seeking succession grows geometrically over the next several years. Some 75 percent of the membership of the American Institute of CPAs will be eligible to retire by 2020, and more than 60 percent of all equity partners in the U.S. are over the age of 50. In fact, one person turns 65 in this country every eight seconds. That's a real succession crisis. Having good metrics, a good staff and embracing new technologies will help make your firm more attractive as well.

Koltin: When I consult with firms on succession, we typically create two plans that I refer to as the "simultaneous equation." We build out a plan for internal succession, along with the necessary changes/hard decisions and capital investments that will be required. While we are doing this, we also "kick the tires" on external succession so that we have all the information necessary, in terms of making the best informed decision possible.

Berger: Partnership agreements should provide for a transition of leadership to the next generation. While the partnership agreement should provide for a transition in management (e.g., election of new members of an executive committee by the partners as a whole), the current management must convey an attitude and practice that they can rely on the next generation to manage the practice. Beyond what the agreement says, are today's leaders giving the rising potential leaders the opportunity to learn about managing the firm? Do the senior partners trust the younger partners to take over? If not, it is equivalent to handing the keys to an expensive sports car to someone who just passed his driving test. You can't teach leadership, and nothing can substitute for experience. The best way to gain the experience is for the younger partner to learn how to manage and grow a firm, while the more senior and more experience partner is still active.

Nisberg: Firstly, have reasonable expectations. Think "win-win," not "win-lose," and work to create a fair and equitable arrangement. Buyers can disappear quickly when unreasonable sellers become obvious. It is often useful to introduce a third-party advisor into the process early as a facilitator. It is also important to clean up any apparent "mess" that the sellers know exist. Don't hand the buyers a bunch of headaches if avoidable. Clean up your own mess before looking for a buyer. This always makes a deal easier. Problem partners or problem clients can slow down a sale. It is also much more likely to do a deal after a good profitable year than after a downward trend in firm growth.

Berger: If the firm will be relying on a merger or sale transaction to implement a retirement plan, then it needs to make sure that:

- The clients will continue their relationship with the new firm;
- The younger generation will continue with the new firm; and,
- The retirement package they expect is reasonably related to the practice sold.

To ensure that the clients of the selling firm will continue with the new firm, the selling firm must make sure that the clients are comfortable with the change in the professionals. Less change in the identity of the professional servicing the account will mean a greater likelihood of continuity. Therefore, the retiring partners must make sure that his or her younger partners are familiar with the clients and their service needs, and the clients must be familiar with such other professionals. Clients will expect the transition between firms to be seamless. Prior to the merger, the senior partners must take actions to make sure that clients are comfortable with other personnel at the old firm. When the transaction occurs, the senior relationship partners at the selling firm should be very involved in the introduction of the new firm and its new service offerings to the clients of the old firm. While this seems fairly intuitive and obvious, it is frightening how often this effort is ignored. Without the transition of the clients' business, there will be nothing to support the retirement payout.

As part of the first premise that a selling firm needs the clients to transition, the selling firm also needs the younger professionals to transition to the new firm. That means that the partners negotiating the transaction must make sure that the younger professionals are provided not only with continued employment but some incentive program to make the transition work. They should be integrated immediately into the buying firm and should be engaged with the new firm in the promotion of the merged firm to the clients. The involvement of the younger partners is a key element of making the merger work.

Finally, many partnership agreements are first-generation partnership agreements, meaning that these are the agreements that the founding partners executed when the firm was formed. In most cases, those agreements provide very lucrative payouts for the founding partners and leave little to the firm left behind. That is a recipe for disaster on many levels: It

creates unreasonable expectations of the founding partners as to what they will get paid in retirement and it provides little incentive for the younger generation to remain with the firm.

If the firm seeks a merger as a means of making the retirement payments, it may be unrealistic for the retiring generation to expect a retirement payout at the level set forth in the first-generation partnership agreement. If that retiring partner does not understand the economics of the marketplace and insists on an unrealistic retirement package, a deal may never get done.
On the other hand, the retiring partner who wants a deal to be done can assist in structuring a transaction that provides the proper incentives to each constituent (retiring partner, continuing partner and purchasing firm) to get the deal done.

### We have seen a great deal of M&A activity among Top 100 firms this year. Will that continue? What's driving it?

Nisberg: Succession planning is the No. 1 reason so many deals are being done. A weak bench with limited confidence in being bought out is a strong motivator to sell. Limited leadership depth, the lack of needed skill set, limited partner ability to bring in new business, a lack of vision and the fear of failure are all drivers in creating a need to sell. Merging or selling will continue to be an aggressive activity on the CPA firm landscape. There are still many firms out there looking for buyers. What's changed are the available high-end firms. Many of the A and B practices have been absorbed. This has made it difficult for buyers. Of course, all sellers think they are an A-level prospect, but we all know that's not true. While there are still many high-quality and highly attractive sellers out there, they are becoming harder to find.

Berger: Merger-mania has been propelled by many factors: the need to extend practices beyond the home region of a firm to match the national and international growth of clients; the need to penetrate new markets quickly; the immediacy of the need for new expertise, particularly in technology sectors and health care sectors; and the sheer need for talented and experienced professionals. Growing clients expect their professionals to grow with them, and accounting firms are acting to anticipate those needs, rather than reacting late to clients' new expectations. Also, it has become more expensive to run an accounting practice; as technology costs soar, the pressures on smaller firms increase. At the same time, rate pressures from clients continue, and firms see the need to reduce marginal operating expenses to react to such rate pressures.

While mergers may continue within the Top 100 Firms, it is more likely that the Top 100 Firms will be reaching to levels below them to add practice niches and geographic reach and to enhance core capabilities.

Sinkin: I would expect the M&A marketplace as a whole to remain at its current rapid pace, and yes, we'll see more consolidation among the Top 100 in the near future. Succession, which is a driving factor behind many mergers, shall only increase with the aging of the current workforce. Technology and the increased adoption of cloud applications have enabled firms to operate out of multiple locations, and as a result, firms can drive synergies even with several offices, which aids in the transition process. Cross-selling of services also continues to feed the M&A frenzy, especially among firms with complementary client services or industry verticals. For example, if Firm A has a number of construction clients and Firm B offers cost segregation services, that makes an almost turnkey cross-selling model post-merger.

Koltin: There is no question in my mind that there will be more mergers of Top 100 Firms in 2015 and 2016. I'm aware of a couple of discussions going on right now involving firms in the Top 50 who are talking to firms in the Top 100, and there is a high likelihood that this trend will, in fact, continue. The landscape is absolutely changing and for the most part, we are finding that both bigger and better are better!

Sinkin: The larger firms will continue to penetrate additional geographic marketplaces; for example, a firm in New York may look to gain a footprint in Atlanta or Miami and seek to merge with firms in those areas where they want to gain a toehold. Once they penetrate a new marketplace with a large initial acquisition, many will turn their focus toward smaller "tuck in" deals to strengthen their bench and grow.

**Some have suggested we might see a merger among the Big Four. Do you see any other major surprises in the works?**

Sinkin: Because of potential anti-trust issues, I think it would be challenging that we'll see any further consolidation among the Big Four. When Arthur Andersen collapsed, one of the biggest fears among regulators was there was now less competition among what was then the Big Five and overnight became the Big Four. Further down in firm size, it's safe to assume a good number of the T100 and even those below that tier are in dialogue with each other and should generate a number of headline-making deals in both the short- and long-term.

Berger: Personally, I don't expect a merger among the Big Four. The power, strength and size of these firms are formidable; for their clients, the competition among the Big Four is an important factor in causing the firms to maintain their service levels at acceptable costs to the clients. It is possible that we may see additional consolidation at the next two levels below the Big Four, as those firms are seeking to lock in places as high-quality alternatives to the Big Four with national and international acceptability.
Nisberg: There will not be another Big Four merger in the foreseeable future. No. 1, the Justice Department will never go for it, and secondly the conflicts in the public sector would make it nearly impossible. I also think that Big Four partners have seen what the fallout had been historically, and they wouldn't want to repeat that process. How many Big Four partners lost their careers as a result of the first round of mergers by the then-Big Eight is not a well-known number, but we know it was a lot. I think the "fool me once, shame on you, fool me twice, shame on me" premise applies here.

What might occur: I can see a Big Four firm absorb a large second-tier firm, or perhaps two second-tier firms may do a deal. No big surprises. Large regionals are talking all the time. As for surprises - maybe a non-CPA firm will make an acquisition, such as FTI or Great Hill Partners has previously done. Maybe an investment bank. These are good acquirers for CPA practices, primarily because they have no idea how to value a CPA firm or what to pay for it.

Koltin: I don't see any chance of a merger amongst the Big Four, but I wouldn't be surprised to see the Big Four try to acquire another Top 20 firm, similar to what KPMG did with Rothstein Kass this past year. If it were to happen, I can think of one firm most similar to what the Big Four would be looking for, but I don't want to start any rumors!