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Spotlight

The State of M&A: 2014

Our virtual roundtable of experts looks at the landscape for firm mergers and acquisitions in the coming year.

As 2013 drew to a close with the now-familiar flurry of last-minute deals, we convened a group of experts in firm combinations to take a look ahead and tell us how they expect the market to change in the year ahead, and what both those who want to sell and those who want to buy need to do to get what they're hoping for.

What new trends, if any, are you seeing in the M&A landscape?

Terry Putney (*CEO, Transition Advisors*): At the top end of the market, based on size, many of the regional and super-regional firms have fulfilled their strategic objectives such as expanding their geographic footprint in recent years. Their subsequent acquisitions need to be more focused on niche services and industries and talent that will remain with the firm. Many markets are experiencing a shortage of experienced labor, reminding us of the market before the economic downturn in 2008. As a result, the availability of talent in an acquisition is becoming a stronger criterion in buyer's eyes. The "Holy Grail," so to speak, for many M&A-minded firms is a young CPA with a good book of business. We are also seeing more "mergers of equals" due to the need for some firms that are seeking upstream mergers to expand the number of potential suitors that are available to them.

Jay Nisberg (*President, Jay Nisberg & Associates*): There seems to be a propensity to more cash deals over time, with approximately 20-25 percent up front. In 2012 I did a significant number of mergers and now I'm seeing more cash change hands. I'm also seeing more mergers being concluded with the impetus being the retention of highly qualified staff and partners.

I'm also starting to see an increase in sole practitioners finding places to tuck themselves in and a willingness by larger regional and local firms to do deals with the smaller boutique firms doing under $1 million.

Allan Koltin, CPA (*CEO, Koltin Consulting Group*): The M&A frenzy that we saw within the Top 200 firms (with revenues of approximately $13 million or greater) has now moved to the small and midsized firms, whereby firms with revenues between $3 million and $13 million are getting extremely active in the M&A game. A day doesn't seem to go by where there isn't an announcement of a merger involving small and midsized firms. Given the succession-planning dilemma that challenges the profession, I don't anticipate this to die down for some time.

With the difficulty many firms have had with organic growth the past couple of years, it is not surprising to see that strategic mergers and acquiring lateral talent have replaced organic growth as the No. 1 growth strategy in the industry. That being said, there are still firms with deep industry and service-line expertise that have been able to continue growing organically at double-digit rates, but they are clearly the exception and not the rule.

Steven Berger (*Attorney, Vedder Price*): While the merger market is still quite active, I see both acquiring firms and firms seeking to sell being more selective and more thorough in their due diligence. Acquiring firms continue to seek growth across strategic lines and geographical boundaries that are complementary with their existing practices. That is, it is no longer growth for growth's sake. The senior partners of selling firms are looking to ensure their retirement plan, but they also recognize that the transaction must provide security and growth opportunities for the younger active partners. The market is still active, but both sides are focusing on finding the right fit. I am also seeing more time spent before the transaction happens on understanding and implementing the significant steps necessary to make the combined firm work smoothly and efficiently following the closing.

Brannon Poe, CPA (*Senior advisor, Poe Group Advisors; author, Accountant's Flight Plan: Best Practices for Today's Firms*): My favorite trend is the one toward creating "income partners." Essentially, this is used where a key person or former owner is paid like a partner but has no ownership interest. This can be very helpful in structuring deals with multiple partners. Quite often, partners will differ on their timing when it comes to exiting. This is a great way to structure compensation for a remaining partner who may want to work for several more years after their partner(s) want to exit. It's also a great way for owners who may be a few years away from a sale to compensate a "star player" without taking on a new partner ... which can complicate exit strategies.

Koltin: It had been predicted that, due to the merger frenzy, there would be tremendous upheaval and many de-mergers over the past couple of years. Surprisingly, there have been very few de-mergers that have taken place. I believe this is due to the fact that firms are much more knowledgeable and sophisticated in terms of both asking the difficult questions up front, as well as having a greater focus on execution once the merger has taken place. I also believe that both the acquirers and acquirees are doing a better job of saying "no" in their initial discussions when they see it won't be a fit (rather than trying to force something to happen).

What are the most important factors that acquiring firms should be considering in the coming year?

Poe: Be intentional about your target. The wrong firm at a good price is a bad deal. You'll never find the perfect practice, but you should think ahead about what is important to you before you start looking. Koltin: My advice to acquiring firms is to make sure that you have uncovered all of the hidden agendas that could exist on the part of the acquiree. This could range from the potential loss of a significant client to in-fighting among certain partners. There could also be a group of staff and managers who don't want partnership, which could be an issue if the acquirer is moving into a geography where they don't already have an office.

Nisberg: The most important factors are:

- The quality of the clients acquired;
- Their ability to pay;
- The values of the partners in the firm to be acquired;
- The level of risk perceived in the client base and the previous track record with respect to litigation;
- Geographic location; and,
- The ages of the partners.

Putney: In larger markets, competition from other potential buyers and the fact that sellers are often very motivated to find a solution means that buyers need to keep the process moving. It is highly likely that a seller will be engaged in discussions with multiple suitors. In the current M&A climate, literally everyone is talking to everyone! Buyers need to focus on being a solution for the selling firm's strategic issues. Too many are only focused on their own internal objectives. In any successful affiliation, you need to have the 4C's -- capacity, continuity, culture and, of course, chemistry. That means the successor firm must demonstrate they have the capacity to take over for the seller; they will provide continuity in services, methods and pricing; they have a culture that is compatible with the seller's and have the chemistry to co-exist. All of the above lead to comfort on the seller's part that their clients will be retained - a critical component to the success and value proposition of the deal.

Berger: There is no doubt that the accounting profession has become more competitive. Economic uncertainty has resulted in rate pressure from clients as well as a need to provide significant value-added services. Acquiring firms need to supplement their service capabilities to answer client needs. As the regulatory environment shifts, accounting firms will need to understand the changes being faced by their clients, especially in the areas of health care, employee benefits (the result of the fall of DOMA), securities regulation (e.g., the new crowdfunding rules) and tax reform. Firms that don't currently have expertise in these areas will need to develop them or acquire them. An acquisition is certainly more expedient than growing it at home, but that will make the market for target firms with these service capabilities more competitive. Acquiring firms, however, should not let the market pressures diminish the need for thorough due diligence.

What are the most important factors that firms that are looking to be acquired should consider?

Nisberg: The values and culture of the acquirer and the vision of leadership, as well as the deal structure and tax exposure on any cash in the deal. Those acquired should be very cognizant of the acquirer's intent to terminate partners or staff, and if they intend to raise fees. And they should also find out whether or not the acquirer is looking to be acquired themselves.

Poe: That depends on timeframe. If you have a few years, you should focus on making your practice the best it can be. Profitability is important and the most profitable practices I've seen are the most focused. Creating a focused practice takes time. It generally requires pruning in the beginning ... which may mean letting go of clients, staff, and unprofitable lines of business. For instance, firms that do only a couple of audits per year generally are losing money and don't know it. If you look at the time that goes into those audits, as well as the time and money in supporting that work, most people discover that doing a small amount of any work is unprofitable. I've seen practices experience amazing growth after increasing capacity through pruning. The new, intentional growth is far more profitable and enjoyable. On the other hand, if you have the need to sell quickly, you need to primarily concentrate on maximizing your exposure to acquiring firms and on finding the best fit.

Koltin: They should initially determine if the acquirer is truly one firm or is a combination of a bunch of sole practitioners with a common brand. In and of itself, this may not be completely bad if the acquiree is looking for total autonomy. Having said

that, united firms are more likely to stay together (and ultimately pay out deferred compensation) versus a loose confederation of practitioners.

Berger: Before undertaking any merger transaction as a seller, a firm should examine its own internal state of affairs. What areas of the firm, whether substantive practice, governance or compensation, concern the partners? Will these concerns be addressed by the combined firm? The selling firm should do just as extensive due diligence on the acquiring firm as the acquiring firm does on the selling firm. The selling firm should examine the structure of the acquiring firm in terms of governance, compensation and retirement. If the practice of the selling firm will comprise a significant part of the combined firm, what roles in the combined firm will be played by the partners of the selling firm?

Putney: Seller's need to be aware of what a potential buyer's objectives are for the deal and try to help them achieve those objectives without giving away the proverbial store. Very few deals are lost over pricing if the seller's expectations are reasonable. When deals are lost it is usually because the buyer was restricted in executing their business plan by the seller's must-haves. Examples of that are not being able move their office even if a lease is not a factor, having to retain high-priced, redundant staff, or deal terms that would require a significant upfront cash outlay.

Koltin: The acquiree should also be asking how the combination will enhance the career opportunities and training of their staff, as well as provide an enhanced platform for better servicing existing clients (i.e., through deeper industry and/or service-line expertise).

What can firms do to make themselves more attractive as M&A partners?

Berger: Whether a firm is buyer or seller, the firm should make sure its own house is in order before undertaking a transaction. The constituency of the firm needs to be behind the transaction, or at least the concept of the transaction. Especially for a selling firm, if there is deep internal strife prior to undertaking a transaction, it is going to be difficult to get the partners to agree on a deal without first establishing a mutuality of interest. Management of the selling firm needs to understand its partners' concerns; the failure to do so in advance could result in last-minute defections that will ultimately change the economics of the deal for all. The acquiring firm needs to be realistic on how to incorporate the practice of the selling firm. Both firms need to understand the costs of integration are higher than they expect, and that it takes time before the combined firm is operating smoothly and profitably. Both firms need to approach the process with an open mind and flexibility, recognizing that each has strengths that should be preserved.

Poe: When people are buying a business, they are essentially buying a future stream of cash flow. Cash is king, so if you are planning on a sale in a few years, take steps to increase owner cash flow. ... I studied some of the most successful practices we've sold and found out what has worked. My quick answer to improve owner cash flow is ... focus. Figure out what you are best at and do more of that. Figure out what you need to stop doing and stop doing that. Oh ... and switch to value pricing.

Nisberg: They should get rid of underperforming partners before showing the baggage to an acquirer. Then get rid of underperforming clients, and then settle any litigation that's active. Time your interest in selling when your firm looks most productive.

Putney: If you take away the signage, most firms cosmetically resemble each other - every firm has desks and cubicles, computers and filing cabinets. Therefore much of the focus on "airbrushing" your firm to become more enticing to a potential successor firm has to be almost exclusively internal.

Do you truly know your firm's metrics? Not just in terms of billings or gross profits but key performance indicators like margins, salaries, income per partner, receivables, realization and utilization. Mergees who are unsure, or tell inquisitive potential suitors they'll "get back to them on that," leave doubts about the organization and efficiency of the practice and its leadership.

What about your IT systems -- are you a progressive firm on the cloud and employ a paperless initiative or are you using outdated software programs and are your hallways a repository of paper stacks?

Are you immediately portable, or is your firm locked into a multi-year lease? Can your space be expanded if necessary? Have you determined who are your key people and which of the staff don't have to be part of the succession plan if the buyer finds them expendable?
Remain as flexible as possible. Buyers need to know that sellers are most concerned that they will be paid. They usually express that as, "Pay me as fast as possible and with the lowest risk of price adjustment as possible." There are a lot of things a buyer can do short of writing a big check at closing and fixing the price upfront that can make a seller comfortable they'll get paid and still make the deal very profitable for the buyer.

Sellers need to keep in mind that buyers are buying their practice to generate a profit and most firms define that as annual cash flow. ... Try to eliminate as many obstacles as you can for the buyer so they can afford to pay you more for the practice.

Koltin: This is a simple one. Be as upfront with the acquirer as possible. Understand in the negotiation that you're dealing with your potential future partners, and the more objective and truthful you can be about your firm, the better it will be for all sides. I can't stress enough the importance of a firm considering an upstream merger to get outside, third-party advice from someone up front. They will be extremely candid with you, both in terms of a reality check on the value of your practice, as well as helping you to determine if there are certain decisions or results that need to take place before testing the upstream merger market (e.g., if you have a partner that no one can stand, it is advisable to get rid of the partner first before bringing "tainted goods" to the negotiation table!).

Where do you think prices are heading? Can sellers still count on the multiples of the past?

Koltin: The question of firm value comes up all the time and I chuckle when I see people make the comments that, "It's a seller's market" or "It's a buyer's market." The reality is that if you're the acquiree and you're a highly successful firm (great growth, profitability and talent), you can command a premium and firms will probably line up to talk to you. But if your firm has been flat with average to below-average profitability and you have not been able to develop a deep bench of talent, guess what? You'll probably be lucky to get 50-70 percent of fees as a valuation price. I always advise acquirees not to get hung up on deal value or purchase price, as there are so many other factors that ultimately determine value (i.e., who will be a partner after the deal, what compensation guarantees might exist, capital gains treatment, etc.).

Putney: In a word, no! As a result of the predicted increase in the number of firms seeking either sales or mergers to solve succession issues, and due to the laws of supply and demand, the multiples that firms are currently receiving have decreased from the levels of even just a few years ago. This is especially the case with midsized firms, because there are fewer potential buyers than for small firms; many of the potential buyers have already met a strategic objective in their market, such as establishing a footprint which means they can be more selective with additional deals; and many midsized firms that need succession have waited until the last minute and are no longer attractive candidates for larger firms, which traditionally want more from a deal than simply acquiring additional volume.

Small firms (those with one to three partners) have seen a somewhat less dramatic decrease. Potential successors to these firms are often motivated by the opportunity to acquire additional volume and the economics of an acquisition still make sense at multiples close to what they were previously. However, what we don't see as often as we did five years ago is the super-premium pricing at ranges of 1.5X and higher. We also see terms other than multiples being modified so that upfront cash is much lower, buyers are unlikely to budge on retention periods, and other factors affecting cash flow and profitability of the deal might be handled differently.

Buyer firms that sense they are one of the only options in a smaller market are much more likely to push the valuations down because they often sense that seller firms don't have as many suitor opportunities. Buyer firms for smaller practices in large metro areas, such as New York and Chicago, continue to be reasonably motivated on pricing due to the potential competition from numerous other firms in the market.

Nisberg: Yes. The traditional multiple of one times gross fees collected in the previous year is solid. I don't see any uptick here, and in some cases the number could be less.

Berger: The emphasis now is on seeking retention of the business of the acquired firm. Consideration is being structured based on measurement of the business that remains at various intervals following the closing. Acquiring firms depend upon the sellers to transition clients not only at the outset but over a period of time. This is true for compensation of the seller's partners who remain with the combined firm as well as for the retiring partners of the selling firm. Whether an acquiring firm pays a multiple may vary depending upon upfront consideration versus payments over time.

I don't see firms paying on huge multiples in either case. I see structures using floors and maximums on the basis of the business retained. Both the acquiring firm and the selling firm need to share the risk of the retention of the business, and that concept is working its way into deal structures.

Poe: There are so many factors that can impact prices, so it's difficult to predict. Prices declined in 2008-2009 and have slowly recovered since then, but are not at levels that we saw prior to the financial crisis. ... In the long term, say 10 years, my hunch is that prices may decline somewhat because of demographics, but there will always be strong demand for good practices.

One thing I can say with certainty is that accountants who provide value for clients beyond basic compliance will do well in the future. Accountants who treat their services like a commodity will not fare as well.