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Major changes ahead in M&A

By Daniel Hood
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More than a decade of continuous high-volume merger & acquisition activity among accounting firms has masked the emergence of a number of new trends in the area in 2018 and 2019, according to a virtual roundtable of experts convened by *Accounting Today*.

From declining valuations and pickier acquirers to a greater focus on combining with non-CPA firms, our panel of experts sees major changes in the market for 2019, and has both serious warnings and specific advice for firms looking to get involved in M&A in the next 12 months.

How would you characterize the market for accounting firm M&A in 2019?

Bob Lewis, president and founder of The Visionary Group: Aggressive but with a more selective approach. The CPA M&A market is exploding. That seems hard to believe based on the last decade, but firms' exit strategy positions are getting worse. What's fueling the M&A activity, beyond aging management, is the extensive number of regulatory changes and the material investment firms are looking at with technology due to risk management and IT security issues. In addition, many firms do not have a stable succession plan or have senior staff that can bring in work, and they continue to age.

Acquiring or merging in another firm is more common than ever, but the acquirers have become more strategic. For the last several years it has been less about pure revenue growth, and more about alignment with either their existing practice or penetration into new geographic locations.

Allan Koltin, CEO of Koltin Consulting Group: I think we've had more change in the past year or so in terms of M&A than in the past decade – it's been that big a year. This last year was a game-changer in a way I've never seen before. ... There were some noticeable trends that I think are going to continue over the next couple of years. The first one is that it appears that valuations of CPA firms for the first time in quite some time are reducing. The last 10 years have sort of been the go-go years of growth and higher profitability, but the harsh reality today is that there are going to be two major changes that will challenge or reduce earnings over the next decade.

The first one gets talked about the most — it's technology, and audits moving to artificial intelligence and machine learning and robotics, and concern about a major reduction in audit fees. Also, this next wave of technology won't be cheap, and firms will need to make much more significant investments than in the past. The second challenge is a byproduct of the first -- the migration away from compliance shops to building out firms' consulting, advisory and outsourced services. What acquirers are learning is that when they try to acquire those types of companies, they don't want the typical CPA firm deal. In the typical deal, you get deferred comp for 10 years as ordinary income. This next wave of acquisition candidates comes with a little bit of an edge – they've been talking to private equity, they want cash on the barrelhead. They are a challenge to the traditional way CPA firms have done deals.

Joel Sinkin, president of Transition Advisors: We believe the activity level will be very strong and we will continue to see much of the market switch more and more to a buyer's marketplace. Values will continue to fall, and many potential successor firms will be very specific about target firms meeting certain expectations. Firms where all or most of their partners are seeking short-term succession will be far less interesting to many successor firms, as compared to practices that come with younger partners. Firms with specialty client niches will also be coveted more than those with traditional offerings.

Ira Rosenbloom, chief operating executive of Optimum Strategies: Signs point to a very active year for accounting firm M&A in 2019. The exit-motivated players are increasing in numbers and are very challenged by staffing and tax law pressures, which make them even more interested in deals.

Larger firms want to expand their market presence, and increase the distribution of their service platforms, so they view acquisitions or merging in other firms as a powerful way to achieve their goals.

There are a growing number of firms that view M&A as a realistic way to enhance staff recruiting, staff retention and to develop economies of scale, so mergers of equals or close to equals are enjoying strong momentum right now. Dialogue and conversations will continue to be robust, and that should translate into a strong year for closings.

Terry Putney, CEO of Transition Advisors: We don't see any let up in the market. All the factors that have been driving activity remain and some are even more prevalent. On the seller/merging-up side, partner succession is even more challenging for many firms due to the tight labor market and competition for talent both within and outside the profession. Small and midsized firms often have no alternative other than to sell or merge to provide a succession solution. Added to that is a lot of uncertainty about forces of change in the profession due to technology and regulatory shifts. Many firms are asking themselves if they will be strong enough to succeed or if they should combine with a larger organization. On the acquirer side, M&A continues to be the most certain and quickest way to execute strategic objectives. Our clients tell us roughly two-thirds of their growth in the near future will come from M&A. Most firms we work with are seeking to execute geographic expansion and acquire new service lines through M&A.

Koltin: The other thing I've noticed is that when I reach out to acquirers and say I've got a $3 million or $5 million or $10 million or even a $20 million CPA firm that's heavy on tax and compliance, the excitement level isn't there like it used to be. They say, "Allan, those are dated goods" – meaning, as AI migrates into the compliance space, a lot of that work is going to evaporate, and that which remains may not be that profitable. That has been an enormous change. Obviously, the bigger the firm is, the more pressure they are feeling to use whatever investment capital they have to focus more on consulting, advisory and outsourced practices.

Of course, for every negative, there's a positive – and the positive here is that the midsized firms – those from $10-100 million – I think will now have more opportunities, and less competition from the top 25 firms, who are going off on a different journey. ...

The other noticeable big change is that firms that are between $20 and $100 million – the top 150 firms or so – more of them are in play – talking about an upstream merger – than I have ever seen before. I'd say there are more firms in that discussion this year than in the last five years combined. Those firms are taking a really hard look at the required investment capital and risk to recreate their firm to compete at the next level. Is it worth the investment and worth the risk?

What should would-be acquirers be bearing in mind most in 2019?

Putney: There is a prevailing thought that the market has shifted to a buyer's market from a seller's market and that as a result you can acquire firms for much lower prices than in the recent past. To a certain extent that is true. However, we are seeing an increasing number of situations where acquirers seeking high-quality opportunities (remember, beauty is in the eye of the beholder) will make very lucrative offers to get a deal done. It isn't always pricing per se, but rather with tax treatment, retention adjustments, upfront payments, etc.
If you feel you might be competing for an opportunity that you really want, be prepared to be flexible to get it. Also, virtually every deal is at least somewhat contingent on client retention, even pure mergers. We see too few acquirers articulate to target firms a clear plan for post-merger integration that emphasizes what will be done to

maximize retention. As a result, the seller or merging firm partners often feel overly at risk for losing value in the deal.

Rosenbloom: Firms should start by creating a plan that includes specific target profile requirements so candidates can be filtered effectively. There will be plenty of firms from which to choose in 2019, so coming up with a list of criteria first will be critical. Then, they need to be disciplined and transparent about the process. Be sure your process allows a full read on the candidates.

One area the acquirer should focus heavily on is firm culture — specifically tendencies of the target firm to avoid progress. The numbers, of course, will be an important guide, but attitudes, vision, and behavior are going to impact the financial results.

All sides must be candid about opportunities and difficulties. If the party being acquired does not express that they have any worries in this potential new relationship, then that would be very unusual -- and may be a red flag!

Lewis: First, look beyond the current financials. A firm that does not provide consulting, client accounting services or wealth management can be a huge win and this does not have to be included in the transaction price. Lack of those services is the result of the firm not having the resources. As the number of available firms continues to increase due to the baby boomer generation seeking exit paths, the firms able to demonstrate a vision and present a cultural fit will rise to the top as a preferred option.

Second, act quickly with an acquisition or merger candidate. Do not underestimate the aggressiveness of other acquiring firms. Agreeing to meet after the busy season, next month, or the "next time I am in town" tells the candidate your interest level is not that strong. The firms that know how to do this well make contact immediately and do not draw out the process.

Third, do not start an initial conversation with a candidate firm with a preset value or deal structure. Get them bought into wanting to be part of you and then get into the firm value.

Sinkin: Just because the market has become more buyer-friendly doesn't mean there isn't competition, especially for the more attractive merger candidates. We have seen, and expect to continue to see, firms where their complacency in keeping the process moving forward has cost them the deal. Keep in mind some highly coveted firms are still getting premium offers as well. Lastly, the "urge to merge" has become so great that some firms still want to force the proverbial round peg into the square hole in terms of a fit. Making sure the cultures align, and the successor firm has the capacity and skillset to replace retiring partners both within the successor firm and the firm they hope to merge in, have never been more important.

Koltin: The thing they're looking at is that they need the merger to be accretive for them – sometimes acquirees will expect to merge up and continue to make the same compensation.

And what about firms that want to be acquired or merged?

Rosenbloom: The traditional, non-specialty practices looking to be acquired or merged will find lots of competition. Profitability, strong operational systems and robust communication will make the competitive difference. Firms looking to be acquired should clean up their house before they start the process. Once their house is in order, they can't wait too long before taking the first meeting with a potential suitor. They should get some perspective ahead of starting a search so that the tendency to push back or push away is minimized. When it comes to the ages of practitioners and practice transfers and transitions, 55 is really becoming the new 65. Finding the right successor may take several years and the kinds of firms looking to be a successor in the coming years may not be a good match, so the sooner they start to identify the right successor, the better.

Creating a questionnaire which addresses daily operating matters will help the parties be sure that synergies are realistic, and changes will not be overwhelming.

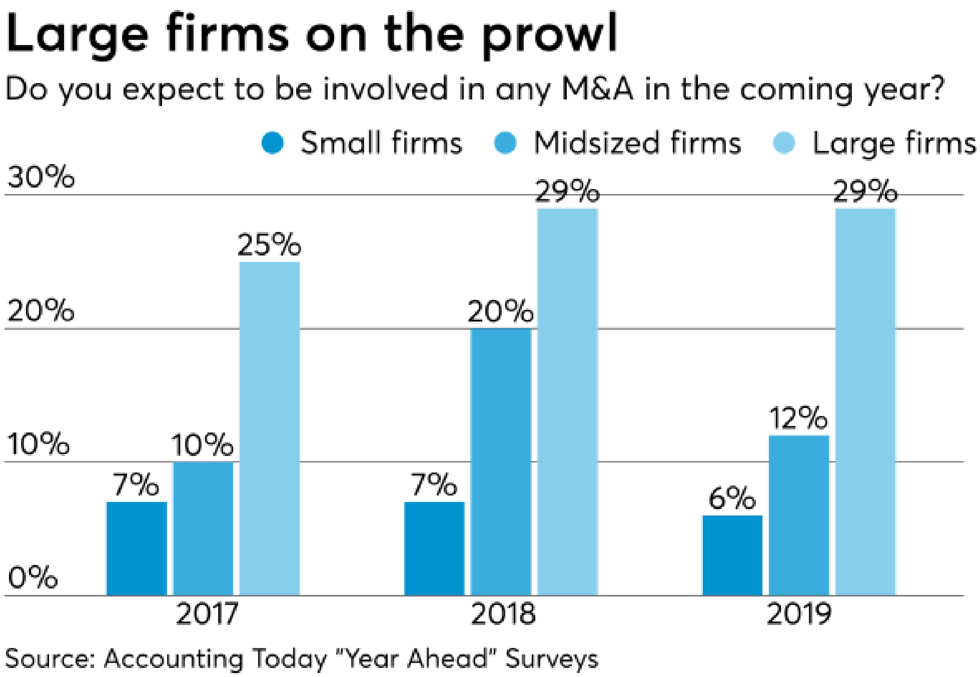
Koltin: The No. 1 thing that acquirees should definitely keep in mind is that a lot of this is timing and market opportunity. They say, “We know we’re going to do something, but we’re going to wait until the bitter end.” What they don’t realize is that the depreciable asset is them, so they’re signing on to a lot lower valuation years from now.

Putney: The No. 1 issue we see now that wasn’t as prevalent in the recent past is the importance of how quickly the selling/merging partners want to retire. Acquiring firms are much more strategic now. It isn’t enough just to dump a client list on them. They want a team in the merging/selling firm that will at least provide a strong transition over several years. Even better is a partner group that will enhance their existing leadership team in the long term. Firms that are waiting until the last minute to find a buyer are becoming less attractive. If you decide to wait to find a firm to buy your firm, just remember you’ll be just selling a client list to a firm that is essentially a financial buyer. Often this leads to a less attractive outcome. Also, many quality buyers have a lot more opportunities to consider than they historically did. They will choose the best available from what is available. Firms with outdated technology, poor management data, and lots of “must haves” tend to be passed over.

Sinkin: There are things you can do to make your firm more attractive. These things include embracing technology and showing an openness to cross-selling niches and service offerings the successor firm may offer. Knowing your real metrics is also important. Recently, we have run into several firms that perform value billing but don’t keep track of their time, so no one knows what is really going on in many areas relating to the time, effort and staff levels it takes to generate their revenues.

A firm with youth adds to your marketability, as well as having clients that are comfortable talking and working with multiple staff members and don’t require the partner to be everything to everyone. Thus, trying to build a “brand-loyal” firm as opposed to an exclusively “partner-loyal” can make your practice more attractive. Lastly, having realistic terms about your merger or sale will create a larger pool of potential successor firms, which is critical. This likely will be the last and most important decision you make relating to your firm; therefore, having a good yardstick of potential suitors is critical.

Lewis: Preparation is key. Most firms are evaluating multiple deals at any given time. If this is the year to begin seeking a potential upward merger, do not underestimate the time and effort it takes to find a cultural fit and develop a financial package that best displays your firm. In addition, understanding the value of your practice helps you understand what a buyer will pay for it. Be clear about what each partner wants. How long do they want to stay? Will they accept an income partner role? What type of compensation and buyout do they expect? Two other factors should be considered. First, be committed. Do not talk to a potential acquirer or merger partner and say, “I am not sure what I want.” You just told them you are not ready and may be difficult to deal with. Second, you need to understand that you may have a say in the firm’s direction, but you will not be in control. If you are not ready to relinquish control, then you should not begin these conversations, because you may burn that bridge with a potential firm that could be a good fit.



What's the biggest misconception that accountants have about accounting firm M&A?

Koltin: The biggest misconception – and there isn't even a close second – the biggest misconception is that all acquirers want is the clients and that they want to get rid of the people. Nothing could be further from the truth. The assets sit with the partners and the associates. Acquirers are trying to figure out how to keep these people and not lose them.

When they go around the table at that first meeting and ask your age and how long you want to work, they're adding that up, and that's an asset. If you're all over 60, that's bad, but if you're all around 37 or 38, and there are a lot of years left, that's great.

The second misconception is that all big firms are bad and bureaucratic. They say, "We left the Big Four and swore we would never go back to that atmosphere." But a lot of firms have done a lot of successful mergers – local firms became regionals, regional firms became mega-regionals, mega-regional firms became national, and national firms became global – and those firms, even though they're big, it's a culture that's more similar to the local firm than they can imagine. When the small firms go through the merger, they find out, "They're not that different from us – they're just bigger with more clients."

Sinkin: Many firms who have not done a merger or acquisition before frequently have two major misconceptions. The first one is not recognizing how this is not just a financial and professional decision for the firm merging up, but also an emotional one. Being patient and understanding with this aspect of the process is something many successor firms don't consider strongly enough. The second major misconception many first-time acquirers have is not recognizing how much capital may be required. This is particularly the case in a merger. Most mergers keep the partners they merge in whole in income, frequently tied into -- at least initially -- that their revenues and time commitment remain steady. Well, if we are keeping them at their current compensation levels, there are also closing and integration costs to consider.

Lewis: First, that a merger or acquisition means the partner will need to immediately exit or exit soon. That is rare. Most deals require a longer transition and some partners being merged in might be there another decade or longer.

Second, how to structure a deal and typical deal terms. Two examples are floors and how long a buyout takes. Another misconception is cash in deals. One firm we spoke with recently thought a $4 million opportunity meant they needed to pay the firm they were looking at acquiring $4 million in cash up front. Conversely, a seller thought they would get 1.25 times the value in cash up front, plus receive their full current compensation ongoing.

Finally, we hear, “We did a deal years ago and it was a disaster.” Conducting a successful deal takes experience. Without guidance, you have a high risk of a poor outcome because you were learning. Consult with an experienced advisor. Even if you do not engage an M&A advisor, most advisors will spend 30 minutes with you at no cost. If they won’t, you probably need to find a different advisor.

Putney: Sellers tend to underestimate the importance of the professionals in their firm below the partner level. They tend to pump up the importance of the partners and downplay the staff. We hear all the time that a buyer has lost interest in a firm because the firm’s staff is weak. Turns out that is what the partners in that firm told them. A frequent problem on both sides is failing to understand the best deal is one that benefits both parties and compromise is the way to achieve that. Sometimes the parties will come to the table with must haves and not give any thought to how that affects the other side. We have rarely seen a must-have that can’t be modified in some way to accommodate the other side’s needs as well.

Rosenbloom: There is way too much affinity for driving the M&A process through the numbers and spreadsheets. Too many deals look right on paper, but don’t pan out because there was inadequate planning for integration, no hard-core details for transition, no marketing and communication plan, and lax accountability, including mandatory times to review and update the process. Not only should firms design these elements upfront, they should also schedule check-ins to make sure it’s working, for example, 30-, 60-, and 90-day check-ins.

The vision for the combined group’s performance and the implementation will not only be relevant to the success of the deal, but needs to be considered when framing the financial components of the transactions. Often, transactions evolve to include incentives and hurdles which were not part of the original models.

As much as 20 percent of large-firm mergers involve non-CPA firms. Do you see that trend continuing?

Sinkin: We see this trend expanding and becoming even a higher percentage of large-firm deals. Most firms rightfully expect technologies such as AI, blockchain, data analytics, etc., to have a substantially negative impact on revenue generation from traditional accounting services. We have consulted on several niche mergers and only see the demand increasing, adding cyber security, HR departments, IT, wealth management, litigation support and many more niches. The benefits of these mergers not only add revenue, but by penetrating clients with additional services, they can create deeper relationships and stronger client retention.

Rosenbloom: The trend will continue for sure. Too much fee pressure on traditional compliance is fueling a lot of the diversification, and it also can be a good feeder.

Firms with headcounts of 30-75 people would be well-advised to pursue non-CPA firm opportunities to strengthen their likelihood to remain independent and to become more attractive to new talent able to serve clients in new ways.
There is growing buzz about bringing more non-accountants into CPA firms to be part of the client service team, and doing deals with non-CPA businesses will create the pipeline to those kinds of people and will make CPA firm more interesting to potential hires in general.

Small, progressive firms would be interested but they would face many challenges to attract and close transactions.

Putney: This is clearly a big trend in the profession as it moves from dependence on compliance services (tax preparation and audits) to value-added consulting that even expands beyond financial management. Many firms are going through a pretty steep learning curve with how to combine with professionals in non-traditional service areas. Cybersecurity is a big one we have had a lot involvement with this past year. We see that continuing and believe the profession is at the starting line still. You can't manage non-traditional professionals the same way as your core business. Deal structures for mergers often must be different, including in some cases a significant difference in valuation. The predicted shifts that will impact the profession do not exclude small firms. But the challenges of accessing those solutions are clearly greater for smaller firms. They may find their best options are affiliating with larger organizations to access the services even to the point of merging to stay viable for their best clients.

Lewis: This trend will continue to grow. Artificial intelligence is forecasting interruptions to compliance revenue streams. Firms are proactively looking to replace potential lost revenue, as well as create new revenue streams. Our CPA M&A team regularly receives inquiries seeking to add wealth management, human resources, management consulting, and technology firms. Although today most of this activity is with larger firms, regional and midsized firms are showing strong interest in diversifying their practices to expand towards an integrated advisory model.

Firms are looking at their existing client base and understanding they have a large group of clients that already trust them, but they are only addressing a limited number of their needs. Think of a hot dog vendor who has a customer come to buy a hot dog, but the vendor does not sell drinks, chips, desserts, etc. That vendor can materially increase their revenue and make the client experience more satisfying by being able to offer these items. A CPA firm is no different. Their clients have more needs than a tax return or financial statement. Adding non-CPA traditional services is one method of increasing the value added to a client.

Koltin: What's happening is that the Top 100 Firms are not saying that they're shutting down their CPA firm M&A program, but that they've raised the bar on what they're willing to look at. I'll get a list from a firm and they'll have four markets that they're interested in – either they're not there or they're there but not in a big way – and they'll say, "These are our priorities." I'll say, "Why is the list so small?," and they'll say, "We only have so much gunpowder, and the rest is focused on building out our non-CPA practices."

It used to be that when I called with a CPA firm opportunity, before I could finish talking about the firm, the CEO would stop me and say, "You had me at hello." Now they say, "We're just not interested." They're balancing a new portfolio. If their consulting revenues are 10-15 percent, you know they're looking to grow that something more like 30 or 35 percent.

The projections are that we will have many more retirements of baby boomers in the next decade than we've had in the past. If that's factual -- and I believe it is -- that sets up a crazy scenario where you have a group with exponential numbers looking to sell, and bigger firms moving in the opposite direction. I had a firm that's in play say to me that if they don't sell soon, the opportunity to sell may not exist in the next five years.
You'll see more non-traditional firm mergers in the top 25, but the next hundred or so firms will step up and fill that void in terms of acquiring CPA firms.

This is the first time I've seen the landscape moving and changing, and I don't see it reversing itself.