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Private equity’s push into accounting

The purchase of EisnerAmper is PE’s first deal with a top 20 firm, but it likely won’t be the last.

By Jeff Drew
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Allan D. Koltin. (Photo courtesy of Koltin Consulting Group.)

More than a few eyebrows were raised in August when the news broke that TowerBrook Capital Partners had struck a deal to purchase an ownership interest in EisnerAmper LLP, the first such deal between a private-equity concern and a top 20 accounting firm.

The financial terms of the agreement were not disclosed, but EisnerAmper said it would use the capital invested by TowerBrook to fuel long-term growth plans. Because audit firms cannot be majority owned by non-CPAs, the deal split EisnerAmper into two entities — an attest firm owned by CPA partners called EisnerAmper LLP and a tax and consulting business called Eisner Advisory Group LLC.

A similar structure was used in private-equity deal with a top 100 CPA firm, this one announced in mid-September. Lightyear Capital announced that it is buying into Schellman & Co., LLC, a firm with $77.36 million in annual revenue that ranked No. 65 in the *Accounting Today* 2021 list of the 100 largest U.S. firms. The deal, financial terms of which were not disclosed, splits Schellman into two entities, a licensed CPA firm called Schellman, which will perform attest services, and the new Schellman Compliance LLC,

which will perform nonattest services such as information technology and cybersecurity audits and assessments.

What does the infusion of private equity into very large U.S. accounting firms portend for the profession? That is at the crux of a series of questions the *JofA* posed to Koltin Consulting Group CEO Allan D. Koltin, who has served as an adviser and broker on many of the biggest merger-and-acquisition deals in the accounting space. EisnerAmper is a client of Koltin's, though he was not directly involved in the deal with TowerBrook. An edited transcript of the *JofA*'s conversation with Koltin follows.

Is the EisnerAmper deal the first private-equity deal with a top 20 accounting firm?

Allen D. Koltin: Yes, what's fascinating is the journey of private equity entering the top 20 CPA firm market started amazingly back in 2006. EisnerAmper was private equity's third attempt. The great recession of 2008 killed the first opportunity. There was another attempt in 2012, but the accounting profession then really didn't need the capital like it needs it today.

Do you see the EisnerAmper deal sparking a flurry of similar deals?

Koltin: I would make a bold prediction here that in the next month, there will be a second top 20 firm to go the way of private equity.

But I wouldn't stop there. I think we could wake up a year from today and there could be no less than three, maybe even as many as four, of the top 20 CPA firms owned by private equity.

When you say owned by private equity, what percentage of the accounting firm is being purchased?

Koltin: A non-CPA firm cannot own an attest firm, so there's what's called the alternative practice structure. Because the buyer, in this case the private-equity firm, cannot purchase the audit practice, they take an ownership interest in the tax and consulting business. Essentially, they're buying a majority of the firm, typically something more than 50% but probably not more than 75%.

The way private equity typically works is they hold the ownership stake in the acquired company for four to seven years and then they'll sell it to a larger private-equity group. The benefit to the CPA firm partners is they get ownership shares in the new entity, which hopefully will appreciate in value during the time they own it.

By not buying the entire business, they're leaving a lot of equity and upside on the table for younger and maybe, to a lesser degree, older partners to take advantage of.

Why is private equity interested in accounting firms?

Koltin: First, they look at the accounting profession as being recession-proof. As you know, many accounting firms had one of their best years last year and the results through nine months this year would suggest the same.

Number 2, they are low-risk businesses. Accounting firms are somewhat insulated.

Number 3 is positive cash flow. More than 50% of the revenue, and in some firms up to 80%, is annuity work, whether it's called an audit or a tax return or a maintenance agreement on the technology side. It's a predictable business with not a lot of volatility.

Probably the X factor is that accountants are trustworthy. They've got ethics and high integrity. And private equity looks at all those things.

The last thing I think private equity sees is the fourth industrial revolution, and they see that the services that got accounting firms to the dance will no longer keep them at the dance. Compliance work is beginning an "evaporation," whether it's a bot that can do in a nanosecond what used to take 200 billable hours, or the ability to offshore or onshore work into lower cost centers. As that's happening, clients are demanding that wave of services in the consulting, advisory, and outsourcing space that are value-added.

We refer to compliance as a type 1 service, meaning a service that a client rarely wants but needs because it's required by a third-party regulatory or financial institution. Alternatively, consulting and advisory are type 2 services. A type 2 service is one that clients both want and need. Because these services are deemed to be value-added, the client pays full rates and oftentimes refers other potential clients to the firm.

CPA firms understand that they need to expand into type 2 services, but ask, "where are we going to get the capital to acquire the consulting, advisory, and outsourcing-type companies to expand our services?" That's where private equity comes in.

Is private equity mainly interested in only the largest firms?

Koltin: Private-equity firms are mainly looking at firms from $700 million in annual revenue to $100 million, so from about the 15th-largest firm to the 50th-largest firm. These acquired accounting firms are what I call anchor tenants. Once the private equity lands their anchor tenant, the acquired firm seeks out and talks to firms with between $15 million and $100 million in revenue for potential M&A deals. The PE firms don't want to acquire small accounting firms.

What characteristics would make an accounting firm attractive to private equity?

Koltin: In addition to the size requirement, they have to be highly profitable because part of the deal is giving back to the PE firm some level of your profitability. Private equity is looking for firms that have very, very high average partner compensation, knowing that they can take some of that back and put a multiple on that.

What kind of average partner compensation does a firm need to make private equity an option?

Koltin: I would say if your average equity partner compensation is under $500,000, this probably isn't for you.

If your average equity partner compensation is $700,000 or more, it's probably going to be a much easier deal to do with private equity because you can afford to give back some of your earnings to the house [the PE firm] and still have a decent enough income.

It also would help if some of those higher earners were close to the finish line. Because what that means is they're probably going to retire and the firm is going to replace that partner with a younger partner at a much lower compensation level. For firms considering private equity as an option, a group of high earners closer to the finish line would be a really good thing.

So the trade-off for the partners is you give up part of your annual compensation today in exchange for a significant payment at closing, as well as one or two significant payments three to seven years from closing? Can you drill down on how that works?

Koltin: The largest payment is at closing, but there is typically a second payment about three years after the deal closes if the firm hits certain milestones. These milestones typically have to do with growing EBITDA and overall firm growth.

The last payment, which typically happens in years five to seven, usually occurs when the PE group sells its shares in the accounting firm to a larger PE group. What's important to keep in mind is that the accounting firm partners, as owners in the firm, will also benefit in the proceeds of that sale. It's also important to note that the CPA firm will be part of the approval process as to whom the PE group selects to purchase their investment.

How would you compare the private-equity deal payments with what the partners typically get if they stay an independent CPA firm?

Koltin: In a traditional deal, where the firm remains independent, partners have to wait until they retire to receive their deferred compensation, which gets paid over 10 years without interest and typically in equal payments that are taxed as ordinary income. In the typical private-equity scenario, you are essentially unlocking all your value within a five- to seven-year period, and you receive capital gains tax treatment, which includes a tax rate much lower than that for ordinary income. For the most part, the total value to the CPA firm partners would be two times that which they would have received if they stayed an independent CPA firm.

Another benefit, especially for younger partners, is the final payment would be in roughly five years from the close of the first PE deal. So while oftentimes we talk about the benefits to an older partner, let's assume a partner is 35 years old and planning to retire at age 65. In that scenario they wouldn't receive their deferred compensation until 30 to 40 years down the road. Compare and contrast receiving payments taxed as ordinary income 30 to 40 years from today versus getting payments with capital gains treatments over roughly five years. You don't have to be an accountant to do the math on that one.

But the financial benefits to the partners is not the reason CPA firms are doing these deals today. CPA firms, by definition, are a zero-sum game. Every year, the profit gets paid out to partners. While that model has worked well for decades, CPA firms now need additional capital to invest in the technology and skilled talent needed to build out the next generation of products and services. Whether it's starting a cyber practice or bringing in an international tax practice, CPA firms need capital to transform their business. This is why private equity is relevant today and may not have been as relevant over the past 20 years.

Private-equity firms have a reputation for squeezing as much profit as possible out of an investment. Is there a danger that this trend will lead to the reduction of the quality of services that CPA firms provide?

Koltin: It's a great question, and I will tell you that many, many private-equity firms work that way. Over the past 15 years, the top 25 accounting firms have been educating private equity that public accounting is a people business and that the assets go home every night. They also explained the incredible competition for talent among accounting firms and that if a firm can't pay that talent what they're worth, the talent will leave the firm and work for another firm that will pay them what they are worth.

I think over the past 15 years, private equity has come to realize that large accounting firms can be a really good investment, but it's not going to follow the cookie-cutter process they've used with other kinds of companies and industries they've acquired in the past.

Accounting firm leaders have been very keen to make sure that this is not just good for the older partners, but for the younger partners as well. What that probably means for private equity is that they won't get the same rate of return that they might have gotten on a product-based company or software company or something where the company's assets, i.e., the people, don't go home every night. But they are going to get a really good return as accountants evolve from their clients' most trusted advisers to their most valued advisers.

I think private equity is going to push accounting firms to be more profitable, but not to an extent that risks the quality of services because that would be a major reputational challenge for all parties.

The bottom line is, again, the assets go home every night. Those assets will choose whether they want to come back the next day. If they're treated fairly, if they have upward mobility and they're highly compensated, the belief is they will want to come back.

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