CRAIN'S CHICAGO BUSINESS.

October 27, 2021

Private equity circles a new target: Accounting firms

They're attracted by the twin sirens of accountancy's steady returns and by higher margins on the faster-growing consulting side. Accounting industry leaders are understandably wary.

STEVEN R. STRAHLER

Christopher Geier

Christopher Geier is an unusual CEO for an auditing firm. He isn't a CPA. Geier, who majored in criminal justice in college and later ran a turnaround consulting firm, was hired by Sikich in 2008 to start an investment bank. His rise reflects what's happening in the accounting profession: Only 40% of Chicago-based Sikich's revenue (an estimated $220 million this year) is derived from auditing; the rest comes from consulting and technology-related work.

That shift is leading to another watershed for the accounting industry. Private-equity firms are circling and beginning to invest, attracted by the twin sirens of accountancy's steady returns and by higher margins on the faster-growing consulting side. From accountants' perspective, outside investors can help pay for artificial intelligence and other expensive software upgrades as firms chase cybersecurity and other tech-based opportunities.

But accounting chiefs like Geier and Alan Whitman of Baker Tilly are understandably wary of private equity's ways of operating. They wonder how its leveraged investment model and history of selling off assets and laying off workers in order to service mountains of debt will play out in a professional services. The private-equity model also calls for portfolio companies to be sold again in a few years or taken public.

"I don't know if the model is going to be able to break sustainably into a people-driven business," Whitman says. "We're intrigued, but we have not figured that out."

If it does work, private-equity ownership promises to accelerate consolidation of the hyper-fragmented accounting industry by giving acquirers cash currency to do deals. That means the trend could affect all sizes of firms, many of which are too small to attract private-equity notice. Among 45,000 accounting firms, only nine have at least $1 billion in revenue and the 400th largest has only $6.5 million, according to industry tracker Inside Public Accounting.

"It is groundbreaking for the profession," says Charles Weinstein, who's made an early bet by leading his New York-based accounting firm, EisnerAmper, into a private-equity transaction that closed in August. "It's a sea change for what it means for the ownership of accounting firms." EisnerAmper, with offices on the East and West coasts, wants to expand to Chicago and elsewhere through acquisitions. With the deal, "We think it's going to happen in the very near future," he says.

Because CPA firms aren't allowed to take on outside investors or, depending on state laws, surrender control to them, private equity is investing in their consulting units under newly defined entities. Nevertheless, Weinstein says, the buyer ends up with effective control of the firm. He won't disclose details of the transaction, but Kent Dauten, a managing director of Chicago-based Keystone Capital, which invests in professional services firms, says private-equity stakes in them tend to account for about 60% of ownership, compared with up to 85% in the manufacturing sector.

So far, private-equity shops pursuing accounting industry investments are doing it from New York City and Silicon Valley, but that will change, according to Allan Koltin, a Chicago-based accounting industry dealmaker. "As more private equity comes in, the big-bigs are going to follow, and that goes up to Blackstone. As soon as one breaks the code, it's like a heat-seeking missile."

Koltin says he's involved in three pending deals, some of which could be announced soon and lead to roll-ups that involve Chicago accounting firms.

Private equity is clearly eager to deal. A record 6,000 transactions totaling nearly $800 billion are expected in the industry this year, almost double 2013 figures, according to PitchBook data.

"There's so much money sloshing around in private equity, they'll take a flyer on almost anything," says Jim Peterson, an accounting industry commentator.

Besides investing in firms, private equity is chasing nonaudit pieces of Big Four accounting firms. The Financial Times reported on Oct. 19 that Clayton Dublier & Rice agreed to buy PwC's tax and immigration services business for $2.2 billion—the biggest such transaction by PwC in two decades.

Sikich's Geier says he gets at least two calls a week from private-equity suitors. While cautious, he acknowledges his industry is ripe for outside capital. Firms are heading in two directions, he says, aiming to be in the top 50 by revenue or remain mom-and-pop outfits. In between is a killer, as firms compete for talent and the wherewithal to pay for it.

Already, accounting's traditional audit business, sometimes known as assurance, is feeling the competition for new graduates, says Andrew Imdieke, an assistant professor of accountancy at the University of Notre Dame. "There's much high demand for data analytic skills. That area is growing more than assurance is."

TowerBrook Capital Partners, EisnerAmper's investor, declined to comment on the deal. Based in London and New York, TowerBrook in 2005 was spun out of the (George) Soros Asset Management Group and invests in financial services firms, among others. It once owned Jimmy Choo, the high fashion shoe retailer.

"What they're doing is essentially ending up as employees," says Michael Minnis, a professor of accounting at the University of Chicago Booth School of Business, of sellers. As for Weinstein, Geier says: "His life is going to be a lot different than it was before."

Koltin says private equity is focused on accounting firms with annual revenue of between $75 million and $750 million—from about the 15th to the 65th largest, which besides Sikich includes Plante Moran here. Plante Moran says it's not interested.

For firms that are, junior partners will have an easier time of monetizing the value of their ownership, instead of waiting until retirement. But as any accountant should know, there's a cost to that.

"They're the ones left holding the performance bag," Peterson says. "They're going to have to earn that out."