Navigating the New Accounting Landscape

Private Equity Investments and Firm Strategies

Allan Koltin held up a list of 29 major accounting firm changes — from ESOP formations to private equity infusions to wealth management deals — and said that not only did the transformations take place in the last three years but that the list changes nearly every week.

Koltin, CEO of **Koltin Consulting Group** and a well-known advisor of CPA M&A, used the list to illustrate that the profession has changed more in the last few years than it has since the 1980s.

The 2021 private equity deal between IPA 100 firm **EisnerAmper** and **TowerBrook Capital Partners** was the first to get firm leaders talking and their heads spinning. Since then, the momentum has built and big players such as **Grant Thornton**, **Baker Tilly**, **Cherry Bekaert** and **Citrin Cooperman** have jumped on the private equity train. Next-tier firms, including **Smith+Howard**, **NDH** and **Schellman** have accepted investments as well. Private equity has altered the landscape of the public accounting environment for good.

A recent IPA Pulse Survey gauged the reactions of firm leaders to the private equity explosion and found that the majority are concerned or unsure of the impact. Overall, of the 84 MPs in firms of more than $15 million who responded to the June survey, 19% thought PE would be good for the profession, 35% said the impact would be negative and 40% aren't sure. (See article on page 13).

Why are private equity firms targeting public accounting and why are firms showing so much interest? And how can firms compete? INSIDE Public Accounting turned to Koltin and consultant **Alex Drost** of **Connection Builders** for answers.

"The accounting industry was formed in 1887, so that's 134 years of those two not doing anything together," Koltin said of the private equity-CPA firm linkage. "So what happened in the 135th year?"

Why is **private equity** interested in accounting firms?

Koltin cited the following reasons:

1. Private equity loves positive cash flow.
2. Private equity loves recurring revenues (through financial statements, tax returns and the like).
3. It's a recession-proof business. "We've been in a recession one way or the other over the last four or five years, and the last four or five years have been the best four or five years for many, many IPA top 500 firms."
4. It's a low-risk business. Firms just don't go bust, with Arthur Andersen in the early 2000s being one notable exception.
5. It's a sticky business. "Clients don't leave. They're very loyal to their accounting firm."
6. CPA firms are grossly undervalued. "Historically (using present values), the truth is we sell these firms for 50 cents on the dollar."

Why are **accounting firms** interested in PE?

Koltin says:

1. The financial upside. The way it works now, the firm pays retirement benefits equal to about 2.5 times earnings over 10 years as ordinary income. "Well, private equity comes in and says if you're a foundation or a platform firm, we're going to pay you 10 to 13 times the EBITDA that you bring over. If you're a tuck-in to an existing platform, we'll pay you somewhere between five and eight times the earnings that you deliver to us and it'll be capital gains, and 50% of that will be in a check today at close," Koltin explains. "So it's not like it's a two times, It's not like it's a three times, it's a four to six times better economic deal when you factor in the projected appreciation of the roll-over equity."

2. CPA firms desperately need capital for the three Ts — talent, "firm of the future" technology and transformation, such as moving into advisory services with less reliance on compliance.

3. The changing mindset of the next generation. "The kids today have 1,400 options of things they can do, and most of them pay more money." They understand the changes in the industry and why joining with a capital partner makes sense to make investments and benefit financially on a personal level.

4. The "fatal flaws" of the partnership model. Making tough decisions is difficult to do quickly without a corporate model of governance. For example, an MP comes up with a great idea, but only half the partners want to implement it. What happens next is nothing, Koltin says. "Every partner has the ability to say no, but no one has the ability to say yes.

HOW CAN FIRMS COMPETE?

Drost foresees a "shredding" of the industry with fewer, but much larger, players serving upper middle-market companies that have deep expertise across multiple industries and a broad breadth of services, specifically advisory and consulting.

Smaller firms will look completely different. "I think you are likely to see sizable growth opportunities for $7-million to $15-million firms that are picking up the smaller stuff that the mid-size firms don't want."

In the middle is a "no man's land," where firms have difficulty moving from roughly $75 million to $250 million. "That's the no man's land element and what that is, is a business that is large enough to need to be highly competitive, invest in infrastructure, and continually invest in talent and growth, but not quite big enough to easily adapt through the growing pains," Drost says. "It's a teenager, right? And that part is where businesses are most in danger."

What about a $20-million firm? Drost sees great opportunities for firms of this size if they systematically build a pipeline of talent and invest in the business rather than focus on maximizing partner payouts. "What I don't see working over the long run is the $20-million firm that maintains the status quo approach."

Niche firms also have a bright future, he believes. "With technology becoming more and more accessible for small firms, this presents an opportunity to build a business from the ground up focused on leveraging technology and a more modern approach to client services without having the baggage that most legacy firms are saddled with."

The biggest mistake is doing nothing, says Drost, noting that those firms risk a material deterioration in their enterprise value over the next few years. "Some partners will sit back and think, 'You know, we're fine. Everything's good. It's working. We're making plenty of money. We've got great client relationships, and we're growing at a fine pace.' … until it's not."

This is the first of a three-part series that will cover various angles of private equity's growing influence in the accounting profession. Watch for parts two and three in the fall.