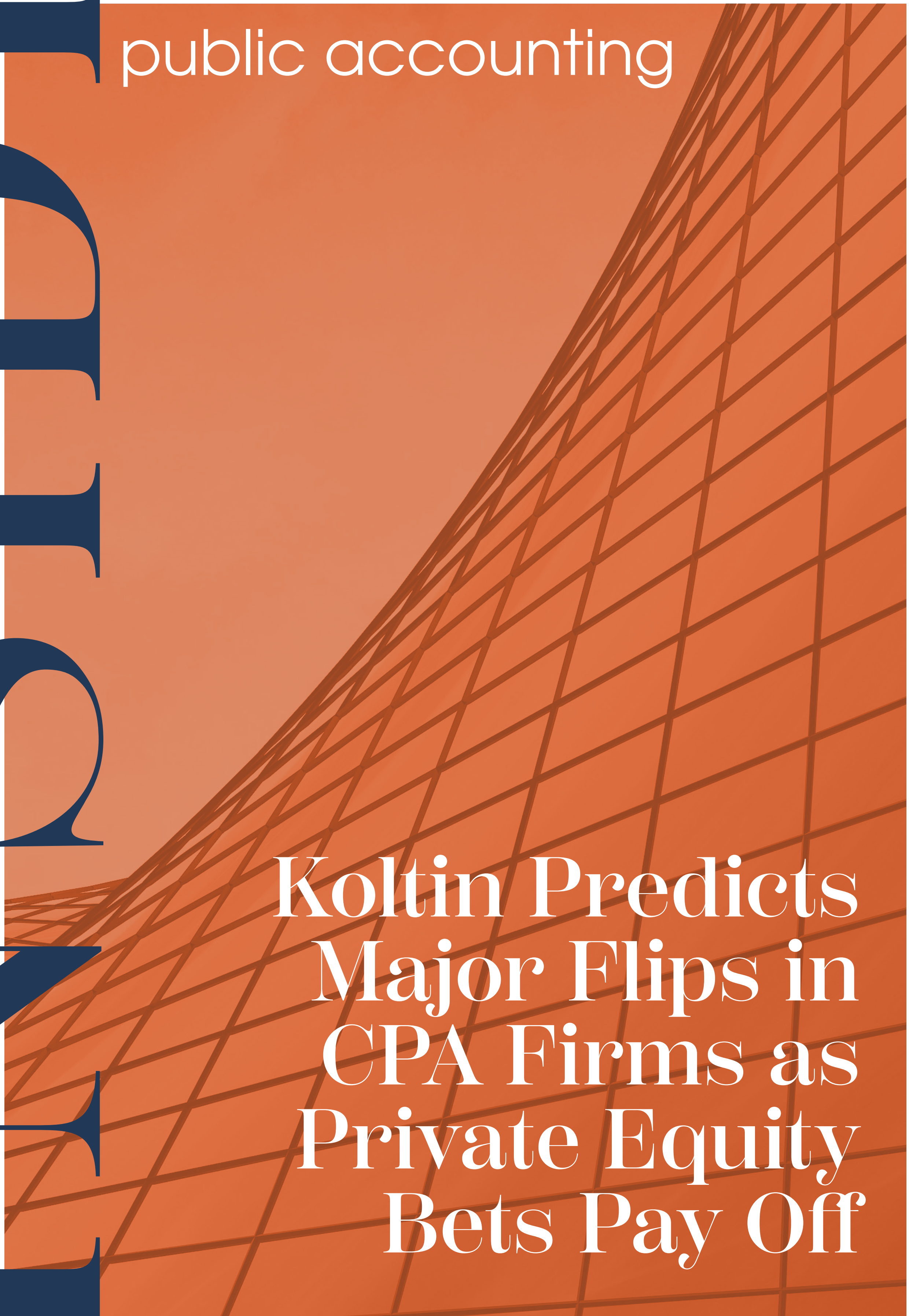
INSIDE public accounting



Koltin Predicts Major Flips in CPA Firms as Private Equity Bets Pay Off

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Koltin Predicts Major Flips in CPA Firms as Private Equity Bets Pay Off

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The public accounting profession is only three years into its relationship with private equity, so it's too early to predict the long-term success, but so far firms that have accepted investments are exceeding financial expectations.

But what happens when it comes time to sell? **Allan Koltin** has a few ideas on what could come next. Koltin, CEO of **Koltin Consulting Group**, believes **Citrin Cooperman**, funded by **New Mountain Capital** in October 2021, may be the first to flip.

Usually, the time frame is five to seven years, but a super-successful partnership may result in a faster sale, perhaps to a larger private equity firm, a large "mother ship" firm that is looking to expand to a new geography, a bigger private equity firm, a sovereign wealth fund, large family office, or even private capital.

WHY CITRIN COOPERMAN?

Citrin Cooperman was a $315-million firm when the buy-in deal was finalized with New Mountain Capital, which paid roughly 11 times EBITDA. By the end of 2024, revenues are projected to be $850 million, Koltin said. "The marketplace has suggested that if that investment were to flip that it could trade somewhere north of a 15 to 16 multiple."

New Mountain Capital has also entered into a second PE deal with **Grant Thornton**. "While they could continue to hold their investment in two top 20 CPA firms, it appears the wisdom will be to sell a significant part of their investment in Citrin Cooperman and to take some chips off the table," Koltin said.

EisnerAmper, the first to take a private equity deal with **Tower Brook Capital**, in July 2021, may be close behind, perhaps by the end of 2025. "That $450-million firm in 2021 should end 2024 with revenues over a billion dollars and have a similar success story as it relates to EBITDA and rollover equity value to what Citrin Cooperman has had." It's been suggested that by that time the multiples will be in the high teens, Koltin said.

SMALLER FIRMS ALSO SEEING SUCCESS

In addition to those two deals, three other mother ship deals took place 18 months to two years ago that are reporting excellent results. **Prosperity Partners** (formerly

NDH) a Chicago-based, $10-million tax and outsourcing firm combined with PE firm **Unity Partners** and grew to $36 million in 18 months. **Cherry Bekaert**, which entered into a PE deal with **Parthenon Capital** in 2022 as a $300-million firm will end the year at $725 million. **Smith + Howard** combined with **Broad Sky Partners** and in two years has gone from $38 million to a projected $100 million by the end of 2025. "Hence, we're seeing success not just in the top 20, but rather, firms of all sizes are finding accelerated ways to grow both their revenues and profitability," Koltin said.

RYAN'S EXPERIENCE MAY BE INSTRUCTIVE

There's only one example within the accounting profession of a private equity flip, which was "uber-successful," Koltin said. He said third-party research suggested Dallas-based Ryan, then a $450-million tax recovery firm and software provider growing single digits a year, received a minority investment by **Onex Partners** in 2018. By 2021, Ryan was at $610 million in revenues and growing double digits a year. In 2022, it then received another significant investment by a private equity fund managed by **Ares Management Corporation**. The company was valued at $2.5 billion, Koltin said. "More important to note is that Ryan has kept its culture alive and strong through its high-growth period."

Additionally, well over 100 professional and financial services firms outside accounting have completed successful flips. They include wealth management, insurance brokerage, advisory, consulting, outsourcing, appraisal, valuation and more. "Because they are all people-centric businesses, one can conclude that the ultimate flips of CPA firm deals could very well be just as successful."


Allan Koltin

ARE VALUATIONS EXCESSIVE?

Some observers are surprised at high valuations, even considering them outlandish, Koltin says, but he notes that accounting firms historically have grossly underestimated the value of their businesses. Firms are probably selling somewhere around 50 cents on the dollar when taking present value into account. "PE firms are not overpaying, they're just adjusting to what we call the new normal."

On the flip in five to seven years, they will have tripled or quadrupled that original value "and everything I'm seeing today would indicate that," Koltin said. "We've all known in business and in life when something sounds too good to be true, it probably isn't true. So far, this has proven to be the exception."

8 Reasons Why the Unexpected Occurs in Private Equity Deals

While the firms that have taken private equity deals so far are succeeding beyond expectations, many more firms have tried and failed to complete the transactions. The causes are many. Allan Koltin, CEO of Koltin Consulting Group, and a top advisor on CPA M&A, shares his thoughts on the eight most common reasons.

1. FIRMS AREN'T PROFITABLE ENOUGH

"If a firm is in the IPA 500, but they're in the bottom 50% of average equity partner compensation, going the way of private equity is probably not going to be a good option for them," Koltin said. "All too often, the PE fund calls me in advance of issuing an IOI (indication of interest) to that firm and says, 'Hey, we think we're going to back out.' And when I ask why they say, 'Well, if we put the offer on the table, they're going to be insulted.' So nothing good can come from that."

2. PARTNERS CAN'T AGREE ON REDUCTIONS OF COMPENSATION

"Scraping" compensation to increase EBITDA can create friction between younger and older partners. Partners who have 30 years ahead of them understandably don't want a big cut in their compensation, but they also want the benefits of a large enterprise value. Some believe the older partners, in their late 50s to mid-60s, should take a bigger cut. "At the end of the day, my belief is it's less about how many years you have left and it's more about those that have excess earnings reducing their comp and contributing to the EBITDA bank."

3. THE FIRM HAS 'NEVER LEFT HOME'

Imagine a large firm that was founded 40 or 50 years ago and has grown steadily at a rate of about 5% a year, but has never merged in another firm and/or expanded their footprint. "Sometimes those firms, because they're large and have been around for a long time, want to be a foundation firm – a mother ship firm," Koltin said. "The PE firm is quick to say, 'You know you've never really attempted that strategy. We don't want to participate in this lab experiment.' "

4. LEADERS CAN'T RALLY THE TROOPS

Going the way of private equity is a lot to absorb. Some partners who have voted a hard no in 2022 are starting to think about it more positively now, in part because of the great successes of early adopters, which took their PE investments in 2021 to 2023. "We as a profession oftentimes are known as the great followers. We don't want to be the early adopter. We don't want to be the one that fails," Koltin said. "We want someone else to do that or prove to us it's a great idea."

5. PARTNERS CAN'T AGREE ON HOW THE PROCEEDS WILL BE ALLOCATED

Even after partners have worked out compensation reductions and created their EBITDA, another dispute can arise, and that is to determine who gets what portion of the proceeds. Most partner agreements don't address a scenario in which the firm gets a substantial check. There are many ways to slice up the pie:

- Current compensation divided by the total compensation pool;
- Current percentage of capital (ownership) divided by the total capital (ownership);
- Years as an equity partner (seniority) divided by the total equity partner years;

- Treat everyone as fully vested in the deferred compensation program and use their proportional percentage of the total deferred compensation benefit.

"The fifth option happens to be the one I like, which is called 'all of the above!' All of those things have merit, but not any one wins the day," Koltin said, "so trust leadership to take all those things into account and make the fair and proper allocations." He added, "In CPA firms, nothing's more divisive than relative partner compensation, so if the firm doesn't already have a closed compensation system in place, I would urge them to consider one because more deals have died over allocation conflicts than anything else in the entire journey."

6. THE PE FIRM MAKES A SURPRISE DECISION

PE firms can pull the rug out from under deals at the end of the process by, for example, changing their minds about the firm leader becoming the CEO or rethinking what constitutes eligible EBITDA. "As the old saying goes, 'once you giveth, you cannot taketh,' and re-trading the deal with your partners never plays well for anyone."

7. A LAWSUIT MAKES THE FIRM UNTOUCHABLE

"If all of a sudden the firm being acquired is hit with a monster lawsuit, they now become what we call 'radioactive.' You can't touch them, probably for a couple years."

8. THE 'ALMIGHTY' THIRD-PARTY Q OF E/DUE DILIGENCE FIRM REDUCES EBITDA

Unlike traditional CPA firm mergers, where the due diligence is done by the acquirer on the acquiree, all PE deals require bringing in an independent third party to verify the EBITDA and related financial information. Many deals have cratered because of revisions recommended by the third-party Q of E firm. Oftentimes, some of the data is subjective and Koltin has seen situations where EBITDA has been reduced by 10% to 25%. "The private equity firm blames the third party and says, 'There's nothing we can do about it,' but the reality is the third party works for the PE firm, so if they really wanted to disagree they absolutely could." Koltin continued, "The harsh reminder we try to tell private equity is accounting is an art, not a science and involves a lot of subjectivity."

In the three years since the first PE deal in accounting, the news is good so far, Koltin said. "All the deals seem to be tracked ahead of what they were budgeted to do. However, what has been uncovered is there are lots of reasons why these things fail on the way to the dance."

Five **Bold** Predictions for 2024-2025

1. In the next couple of months two IPA top 15 CPA firms will combine forces.

2. Five more IPA top 30 firms will accept PE deals in the next six months.

3. One Big 4 firm and one top 25 firm will enter into an IPO.

4. **Grant Thornton**, with PE backing from **New Mountain Capital**, will become the first top 10 firm to cross the ocean and become a truly global firm. Ultimately, most top 10 firms will follow their lead.

5. One PE rollup firm will have revenues in excess of $400 million, making it a top 25 firm; another will have revenues in excess of $200 million, making it a top 40 firm; and two will have revenues over $100 million, making them top 60 firms, and many others will have revenues between $50 million to $100 million, thus making them IPA 100 firms.