

Pricing Issues for

Midsize and Large Firm Sales

Big deals come with more complexity, but size has its advantages.

by Joel Sinkin and Terrence Putney, CPA



It's no simple task for accounting firm owners to figure out how much they should be paid when they are looking to sell. The job is especially complex for firms with at least five owners.

The reasons for that are examined in this article, the second in a three-part series on calculating the price that should be paid for owners' equity in accounting firms. The first article ("Pricing Issues for Small Firm Sales," *JofA*, Oct. 2014, page 24) covered the factors that determine the final sale price for small accounting firms. The final article, which will be published next month, will examine the valuation issues with internal transfers of ownership.

For this series, the authors use the following definitions:

- The term *value* refers to the price to be paid for the practice—which often is expressed as a multiple of revenues. Value is not meant to be consistent with the conclusions that a CPA Accredited in Business Valuation (ABV) would reach in a formal business valuation.
- Large accounting firms are those with five or more owners. That's because firms of that size are much less likely than small firms to be sold outright. With larger firms, at least part of the acquisition is likely to be structured as a merger, with some or all of the owners becoming long-term partners in the successor firm. In those cases, the value of their equity usually is determined by the successor firm's owners' agreement, though not always.

One factor adding to the complexity of large firm acquisitions is the frequent need for different deals for groups of owners in the acquired firm. For instance, a six-owner firm may have four owners who will sign on as partners with the acquiring firm. The other two owners may be seeking a short-term transition of their duties and monetization of their ownership. The deal for those owners may be treated as a sale in a transaction that is mostly separate from the agreement governing the admission of the rest of the owners as equity partners in the acquiring firm.

Another alternative is a two-stage deal for owners seeking transition within five

years but who want to continue working full time for a while (see "A Two-Stage Solution to Succession Procrastination," *JofA*, Oct. 2013, page 40). In some cases, owners of the acquired firm who are not admitted for other reasons (sometimes for not meeting the acquiring firm's book of business or skill requirements for partners) may also go through a sale to deal with their equity.

USE OF ACQUIRED FIRM'S OWNERS' AGREEMENT TERMS

Most large firms have an existing owners' agreement. Some of those agreements contain terms for the buyout of retiring partners that are not financially viable, making the internal succession plan impractical. However, a lot more internal succession strategies fail because the firm's pool of internal successors cannot replace retiring partners. If the motivation for a firm seeking an upstream merger is finding replacements for retiring partners, it may become reasonable to use the terms of the acquired firm's buy-sell agreement for the buyout of owners leaving soon after the merger. This is because the primary concern of the owners in the selling firms is not *what* they will be paid but *that* they will be paid.

For example, a firm owner might be more confident that a \$20 million firm could pay for his or her buyout than a \$5 million firm. Let's say the buyout in the acquired firm's owners' agreement calls for the owner to receive \$100,000 for

the next 10 years. The owner's stake in the acquired firm might be worth more than that on the open market, but to ensure that he or she receives payment, the owner would be happy to keep the payment structure outlined in the acquired firm's owners' agreement.

DEALING WITH IMBALANCES BETWEEN AGREEMENTS

A problem the authors routinely run into is differences between the method of valuing equity in an acquired firm and the firm it is merging into. For example, in a recent deal, a firm with five partners used the percentage of equity owned by a partner multiplied by the firm's revenues to determine the value of a partner's interest at retirement. The firm had five owners, and one owned 60% of the equity.

The acquiring firm used a compensation multiple to determine retirement buyouts. The majority owner in the acquired firm would have been required to take a substantial reduction in the retirement buyout using the acquiring firm's method. However, the acquiring firm concluded it would eventually substantially overpay retirement benefits to all the merging partners if it used the acquired firm's buyout method for the majority selling owner and its standard arrangement for the other merging partners.

The solution was to have all the merging partners sign on to the successor firm's partnership agreement. A separate agreement was established, creating a premium for the majority selling partner (who did not become an equity partner in the successor firm) using





the value he would have been paid from his old firm. A discount was allocated to the remaining four partners merging into the successor firm equal to the “premium” paid to the majority partner in a side agreement with them.

LARGE VS. SMALL

As covered in the first part of this series, the multiples paid in small firm sales tend to be higher than those in large firm transactions. The payout periods also tend to be shorter. The main reason for that is that acquiring firms

tend to absorb less overhead with small firms than they do with large firms. This helps the acquisitions become profitable more quickly.

For example, the acquirers of small practices often have enough excess capacity in terms of staff/partner time and infrastructure that they can absorb the practice with little incremental increases in overhead. In contrast, it is unlikely any acquirer can absorb a \$10 million firm with 60 employees and 10 owners without inheriting the overhead costs associated with administrative staff, leases, etc.

To keep the cash flow of the deal positive, the transaction is more likely to have a lower multiple and longer payout period for the portion of the deal that is treated as a sale.

Not all the terms are worse for the seller in large firm transactions. Deals involving larger firms tend to have shorter retention periods. There are two reasons for this.

First is the nature of the relationships clients have with the firm. A larger firm tends to have more “brand-loyal” clients. These are

clients that do not depend for their services on a personal relationship with an individual at the firm, usually a partner. The clients of smaller firms are much more likely to be loyal to a partner in the firm. Once that partner leaves, there is more risk the client will leave, too.

To motivate the transitioning owner to properly transition client relationships, the transaction will normally be tied directly to the fees generated by the seller’s clients for up to the entire payout period. In the acquisition of a larger firm, there often is less perceived risk of client loss due to the exit of one person from the firm. The acquiring firm may be much more willing to structure the terms using a shorter retention period and even allow some client loss with no adjustment in price.



EXECUTIVE SUMMARY

■ **Large firm sales are much more likely than small firm sales to be at least partially a merger.** In those deals, younger partners from the acquired firm become partners in the acquiring firm, while partners ready to cash out come to terms on a buyout or sale of their stakes to the acquiring firm.

■ **Owners’ agreements often are used to determine partner compensation.** Many times, merging partners will sign on to the terms of the acquiring firm’s owners’ agreement. In other cases, the acquired firm’s agreement is used, or different terms are negotiated.

■ **Large firm sales usually have smaller revenue multiples and longer payout periods than small firm sales.** This is because acquiring firms almost always have to add overhead to accommodate large firm acquisitions. As a result, it takes longer for the acquiring firm to see a return on investment, which leads to the payouts to the acquired firm taking place over a longer period of time.

■ **Large firm sales tend to have shorter client retention periods than small firm sales.** Large firm clients are more likely to be

brand-loyal than small firm clients, who tend to be partner-loyal. Brand-loyal clients are less likely to change accounting firms. Also, in more large firm mergers, at least some partners with the acquired firm stay with the successor firm, maintaining a presence that can help retain clients.

■ **A couple of main factors have created a buyer’s market for larger firms.** The return of organic growth after the recession has relieved the pressure on large firms to expand through M&A. More importantly, the rising tide of partner retirements, cou-

pled with the shallow pool of available replacements, is pushing firms to seek upstream mergers to shore up succession.

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The second reason is tied to the tendency the transaction will be structured at least partially as a merger. At least some of the owners in the acquired firm will become long-term partners in the successor firm. These partners will often be in a position to directly mitigate the risk of client loss and frequently even succeed to the client relationships that were managed by retiring owners who are being bought out. This approach can drastically reduce the potential for client loss and allow the deal for the selling owners to contain less retention risk for them.

However, note that the specific circumstances affecting a firm's potential client attrition will dictate how this is handled. For example, if a selling owner manages an extraordinarily large client in terms of fees, or if the firm has operated in silos—essentially several sole practitioners sharing space and managing separate and distinct books of business—the retention terms may be the same as those for a \$500,000 one-owner firm.

MORE AND MORE A BUYER'S MARKET

While for years it was a seller's marketplace, this is no longer the case in many markets. This is especially true for most large firms seeking sales or mergers. The larger a firm is, the fewer viable acquirers are available. Immediately following the economic downturn in 2008, most growth-oriented accounting firms turned to mergers and acquisitions as an alternative to organic growth, which went dormant as the economy faltered. A feeding frenzy of sorts emerged for firms of all sizes. The M&A market tilted toward sellers. Two things have happened since. The economy improved, and large firms began to grow again organically. More importantly, many more firms of all sizes, other than the largest, are now experiencing succession pressure due to insufficient talent below the partner level.

The firms that are potentially relevant acquirers of large firms remain motivated to grow through M&A. However, the ratio of buyers to sellers has decreased because some of the acquiring firms have them-

selves been acquired, and the supply of available firms seeking an upstream merger has increased dramatically. As a result, most acquirers of large firms have tighter criteria for a deal. Another result is that acquiring firms are pushing the terms they are willing to use in the transaction more in their own favor. Hence, the authors are seeing much more of a buyer's market among large firms.

CONCLUSION

For large firm owners contemplating a sale, it's seller beware. The market favors buyers, and small firms are seen as more attractive for upstream buyers. Nonetheless, large firms can have advantages at buyout time, with more "brand-loyal" clients and the possibility that retained owners from the acquired firm may smooth the transition for retiring partners' clients. ❖

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