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What’s hot and what’s not in firm M&A

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The most common question we used to get was, “What is the current multiple for accounting firm deals?” Now the question is “Is the marketplace for M&A a buyer’s or seller’s market?” The answer, simply stated, is “Yes” — though much depends on the target firm’s makeup, metrics, location, bench strength, opportunities in the client base for cross-selling, and size.

The supply of other sellers in a market versus the number of firms seeking mergers and acquisitions still drives the equation. Some firms who have experienced client attrition due to the pandemic are more motivated to merge or acquire. As a result, they may propose offers that give the impression it is a seller’s market.

In much of the country, the number of firms seeking upstream mergers skews the equation in the direction of a buyer’s market. Although most firms seeking an upstream merger have a partner succession issue, we are seeing an increasing trend toward firms also looking for access to more advisory services, better technologies, and a better competitive position in their respective markets.

A recent trend is when a firm becomes, for one reason or another, especially attractive to a specific acquirer and receives an offer that seems well out of the normal range. Many niche practices are receiving premium offers, which is consistent with a seller’s market. It all depends on the market and specific practices. Firms located in small markets or the outskirts of a larger market may find fewer interested acquirers, leading to a buyer’s market for the firms that are interested.

Another recent trend we have witnessed is the number of potential buyers from outside the accounting profession that have become active in accounting firm M&A. Private equity concerns, wealth management companies, overseas

buyers, and IT firms are now competing with traditional accounting practices for acquisitions — particularly specialty practices. For example, a Jeff Bezos-led venture capital fund just invested $100 million in Pilot, which is essentially a start-up online CAS firm. Firms that find themselves competing against the likes of private equity funds should consider the fact that a 10-year deferred compensation arrangement for the selling owners is not what these alternative buyers are going to offer. The demand for niche practices has created a true seller's marketplace. Alternatively, traditional accounting firms with no strong client niches that primarily offer basic compliance work will by and large find themselves in a buyer's market.

The supply of niche practices for sale compared to the current demand in most cases creates a seller's marketplace. However, a traditional accounting firm with no strong client niches that primarily offers basic compliance work, will by and large find themselves in a buyer's market.

With all that in mind, here are eight major trends — four hot, and four not so hot — in accounting firm M&A to bear in mind for 2021.

What's hot: Overall activity level

During the first half of 2020, M&A activity seemed to grind almost to a halt. Firms could not meet with each other in person, and if they did it was usually via a Zoom or Microsoft Teams call. Everybody was concerned about the negative affect COVID would have on the economy. Many larger CPA firms had suspended or cut back on partner draws and, in some cases, laid off staff.

Fortunately, we now know that 2020 turned out to be better than expected for many firms. As a result, we have seen M&A activity nearly rebound to pre-COVID levels. Many of our clients expect M&A to drive about two-thirds of their overall growth going forward. So, M&A activity on a whole is once again a hot trend and we expect that to continue for the foreseeable future.

Hot: Advisory service acquisitions

Zoran Mircetic

We are seeing an unprecedented number of acquisitions of advisory and niche consulting firms. Cybersecurity was clearly the hot niche over the past couple of years. Currently, client accounting services has emerged as one of the hottest niche acquisitions. IT consulting of all sorts, human resources-based consulting, wealth management, family office, and digital marketing have all become preferred acquisition targets.

We see firms using one of several objectives for acquisitions of niche consulting firms. Acquiring an existing firm is often the most efficient way to launch a new client service niche. We also see firms seek acquisitions to strengthen management and create depth of talent for existing niche offerings. A key for some acquisitions of niche practices is access to a client base that can be cross-sold additional services that the acquired niche firm does not offer.

The following are some observations we have noted during the acquisition process of a niche consulting practice:

- Unless you are only interested in acquiring an existing client base, the talent you are acquiring usually must stay on because in many cases it cannot be easily replaced. This may seem obvious, but niche practices are often available due to the same owner succession issues now affecting traditional accounting firms. Too often, we have seen the post-acquisition business plan treated as an afterthought. Many consulting firm owners are seeking a basic cash out. The selling owner's strategic objectives should be clear from the beginning and align with those of the acquiring firm.
- The demand for consulting practices is usually very strong. Plus, you may very well be competing with firms outside the accounting profession for the acquisition. "Outside" buyers usually are prepared to make stronger offers than CPA firms traditionally do for the acquisition of other CPA practices. In many cases you should expect to see strong down payments, shorter periods

for the remaining payout, and deals structured as a purchase of goodwill. In many cases you should also expect the valuation multiples to be higher than those of traditional accounting firms.

- If you are retaining the owner of the niche firm in a principal position, you usually need to be ready to share the upside of that strategy. Often the owner of a niche practice is proficient at converting leads into actual clients when provided the opportunity. The issue for them often is lead generation. Your client base can provide a rich source of new leads. The acquired firm owner may be expecting the growth generated by the merger to be reflected in their ongoing compensation and eventual retirement buyout.
- Because of the differences in how an acquired principal in a niche practice may be treated compared to the traditional partners in the firm, we sometimes recommend the best structure is to establish the niche practice in a subsidiary entity. That can allow the acquiring firm to manage profitability, principal compensation, and principal retirement buyouts separate from the traditional owner agreement used for traditional accounting firm partners.

Hot: Culture is more important than ever!

Acquiring firms are more intent than ever of finding a cultural fit with target firms. Practices that emphasize a “One Firm” culture often find a merger with an “Eat what you kill” firm hard to facilitate. The plethora of M&A opportunities has allowed firms considered to be “serial acquirers” to be much more focused on finding the “right” firm to merge with. Other examples of culture issues include:

- Use of remote workers and workplaces;
- Virtual versus in-person client interface;
- Partner accountability for performance; and,
- Expectations for working hours.

Hot: Partner status post-merger

With increasing frequency, we have witnessed a situation whereby a current equity partner of the firm merging upstream may not meet the acquiring firm's standards for equity partner status on day one. We traditionally see revenue per equity partner used as the benchmark for how many equity partners can be admitted in a merger. Sometimes the book of business a partner is responsible for managing is used as a proxy for strength, even if that is arbitrary.

Even though this can be a difficult obstacle to overcome, two scenarios are often successful. For example, a weaker equity partner in the acquired firm can be made a non-equity or profit partner in the now-combined firm. The key is to articulate a clear path and the conditions for achieving equity status. However, what is also often overlooked is senior equity partners in the acquired firm that are two to four years from retiring can also be made non-equity "transitioning" partners. In this instance, they may not care if their status is otherwise protected through the formal merger agreement. That can help avoid diluting revenue per equity partner metrics and leave room for less senior equity partners.

What's not hot: Tax practices

Michael Nagle/Bloomberg

The demise of the tax practice has been predicted since 1970, when the idea of a flat tax was first proposed. Now, of course, the futurists for the accounting profession are predicting that technology will replace many of the traditional compliance services, which, of course, includes tax preparation.

We have not seen evidence this is happening yet, but we don't deny the threat appears real. What is important is the larger practices we work with have taken the predictions to heart. Firms that are made up primarily of tax services have fallen out of favor as acquisition targets. Smaller acquiring firms, however, continue to be interested in practices with a heavy practice mix of tax, because their practices are often also oriented toward those services.

Practices with many standalone 1040 clients practically remain in a special category. Unless the client base is ripe for cross-selling other services, the number of interested accounting firm buyers has, for a long time, been very limited.

Not hot: Retiring partners

Unless an acquiring firm is primarily interested in an acquisition to drive its top-line growth and has excess capacity at the partner level, firms seeking an upstream merger or sale with multiple partners needing short-term succession are becoming less attractive. Partners in smaller firms:

- Tend to produce the most revenue on their own time;
- Have most of the control of client relationships; and,
- Often possess the most technical expertise

The need to create the resources necessary to replace these key professionals in short order is more of a headache than a lot of firms want to take on.

Not hot: Office leases

Scott McIntyre/Bloomberg

Unexpired office leases have always been an issue in mergers. The longer the unexpired period and the less flexible the practice is to being moved, the fewer firms will be interested in a merger or acquisition.

This issue has been exacerbated tremendously over the past year. Most of the firms we work with had dramatically changed their operations to accommodate increased remote staff and flexible workspaces. Some of our current clients have nearly transformed into virtual firms and expect to remain that way to a great extent going forward. As a result, they may not need the amount of space they currently use, let alone want to take on another firm's long-term lease. This is especially true if the acquired firm's office is in the general area where they already have a presence.

Not hot: Obsolete technology

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The emphasis the profession is placing on technology has prompted many successor firms to be wary of merging in firms with obsolete or limited technologies.

Recently, a client confided to us that his firm decided to walk away from a potential merger, since the target firm had not even become paperless. The managing partner explained his firm's decision: "It took us years to get our team accustomed to

working paperless as well as using the other IT platforms we now take for granted. We are not prepared to invest that time again with new partners and staff."

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