

Accounting Firm M&As: A Market Update

by Joel Sinkin and Terrence Putney, CPA

The market for mergers and acquisitions in the accounting profession has changed dramatically over the past 18 months. Before the financial crisis in 2008, M&As were viewed more as a tool for acquiring experienced talent and less as a means for growing the top line. The economic shift has contributed to a more vigorous outlook for M&As in the near future. Three factors appear to be at the core of the trend:

- The demographics of the profession are causing a significant increase in the need for external succession in a large number of firms.
- Economic turmoil has created a renewed interest in M&As for firms to sustain growth.
- The globalization of the U.S. economy continues to require that firms provide clients more breadth and depth of services and delivery points.

Prior to 2008, the market for M&As in the accounting profession was moving in a distinct direction. Growth-oriented firms (those firms making up the buy side of the equation) were expanding organically at a significant rate. Staff was hard to find. As a result, many firms were becoming more selective in the business transactions they would consider. Many firms viewed M&As as a method for acquiring partner and staff talent and for achieving strategic objectives such as entering new markets and service offerings rather than as a means of acquiring clients. A solid client base no longer seemed to be enough to attract a lot of buyers to a firm that had a need for an external succession solution.

Abruptly in the fall of 2008, organic

growth stopped. Since many growth-oriented firms require ongoing expansion as a key part of their culture, they started looking at M&As again as a way to grow the top line. This has led to more flexible criteria for M&A candidates in many cases and a significant increase in M&A activity in many markets.

What are the likely trends in the next five to 10 years? In 2007, AICPA President and CEO Barry Melancon and other leaders in the profession believed there would be more mergers and acquisitions in the 10-year period from 2007 to 2017 than in the entire prior 100-year-plus history of the accounting profession in the U.S. The activity since 2007 has proven this assessment to be accurate.



The vast majority of firms are owned by CPAs who are less than 10 years from retirement, and the majority of those firms do not have adequate means for internal succession. According to *The 2008 PCPS Succession Survey* (tinyurl.com/22rcrtr), 65% of sole proprietors were 55 or older. Sixty-three percent of multipartner firms expected at least one owner to retire in the next five years, and 32% of those firms expected two or more partners to retire in the next five years. Thirty-eight percent of multipartner firms said younger members of their firm were not

ready to step into leadership roles. Ninety percent of sole proprietors intended to find or develop some form of succession versus 10% who indicated an intention to hang on until they close up shop. Two-thirds of sole proprietors intended to find an external succession solution (sale or upstream merger). Of the remaining sole proprietors who intended to create an internal solution (admitting partners to buy them out), experience suggests that many will be unsuccessful. This is causing a flood of firms seeking external succession solutions. All of these factors contribute

to the current trend for the "sell side" of the equation.

MERGERS SOUGHT BY NATIONAL AND SUPER-REGIONAL FIRMS

On the "buy side" of the equation, significant mergers in the past year indicate a strong trend toward consolidation of the profession. In 2009, Parente Randolph and Beard Miller Co. merged to form a new super-regional firm in the Mid-Atlantic region and Texas. Marcum & Kliegman and Rachlin LLP merged to create a large New



York/Florida firm. Eisner LLP merged with Amper, Politziner & Mattia LLP to form EisnerAmper LLP, now one of the largest firms in the New York region. J.H. Cohn LLP merged with Good Swartz Brown & Berns LLP, extending the Cohn brand's reach to the West Coast. CBIZ Inc. filled in its footprint on the East Coast by acquiring Mahoney Cohen & Co. and Tofias PC.

The common thread in these mergers is the desire for these firms to create geographic reach either nationally or into major markets. This is the result of a more globalized client base that was once primarily served by what is now the Big Four. This trend is now even going international with the recent merger of Weiser LLP with Mazars Group, a large public accounting firm based in France with a presence in 50 countries.

This trend within the super-regional and newly hatched nationally focused firms (generally the largest 50 firms in the U.S., often referred to as the Major Firms Group) shows no sign of letting up. The largest markets in the U.S. have been targeted for most of this consolidation. As these firms con-

tinue to compete for market share, it is likely the trend will continue into other Top 25 metro areas. This activity will define the opportunities available for firms with 10 or more partners in the near future as this size firm is the target for the largest firms nationally for entry into new markets.

UPSTREAM MERGER OPPORTUNITIES FOR MIDSIZE FIRMS

The demand from larger firms for mergers with midsize firms (three to 10 partners) is still strong, but the question remains as to how that trend will hold. Once new market presence is established by the super-regionals and nationals, the criteria for further growth through M&As become much more selective for what are considered "tuck-ins." Strategic objectives shift to highly sought-after client bases with strong cross-selling possibilities and deep reservoirs of talent in the partner group.

There tends to be less flexibility regarding office location and less tolerance for accommodating short-term succession within the partner group. In many

midsize markets in the U.S., a 15-partner firm may be the largest local firm. If that market has good existing representation of regional and national firms, there may be very few options left for an upstream merger for a midsize firm. We anticipate the market for these firms to take a big hit in the relative near future as the super-regional and national firms fulfill their geographic strategic objectives.

In most major markets in the U.S., there are many firms with three to 10 partners generating \$1 million to \$10 million in annual fees. The opportunity for external succession for these firms depends on the number of firms already in—or interested in—their market that are large enough to acquire them. As firms of this size seeking succession continue to flood the market, they will likely find fewer and fewer solutions available. Once the economy returns to normal, we predict a swing back to a tight market favoring the buyer or acquirer firm. Midsize firms expecting to seek external succession in the near future might be best served to start the

EXECUTIVE SUMMARY

■ **Prior to the 2008 economic meltdown**, many growth-oriented firms looked at mergers and acquisitions as a means of acquiring talent or entering into new markets and service offerings rather than as a means for growing the top line. With the absence of organic growth, many firms are looking at M&As again for growth. This has led to more flexible criteria for M&A candidates and a significant increase in M&A activity in many markets.

■ **The demographics of the profession always contribute to an increase in M&A activity.** The majority of firms owned by CPAs who are less than 10 years away from retirement do not have adequate means for internal succession. This contributes significantly to the need for external suc-

cession through M&As.

■ **Major mergers in the latter part of 2010 indicate a strong trend toward consolidation of the profession** as these firms seek to grow either nationally or in major markets. Firms with 10 or more partners are targets for these larger firms that are looking to enter new markets.

■ **As newly merged super-regional and national firms establish their market presence**, the criteria for further growth through M&As will become more selective. This may decrease the opportunities for an upstream merger for a firm with three to 10 partners. Midsize firms expecting to seek external succession in the near future might be best served to start the process now while the market is still favorable.

■ **The economy has enhanced the demand for acquisition of small firms** (including sole proprietors); this demand is not expected to abate any time soon. The key issue for small firms seeking succession solutions is their proximity to potential buyers to create a market for the firm. Firms in larger metro areas tend to see higher valuations than those in smaller areas due to greater competition between potential suitors.

■ **The greater competition and appetite for mergers within the larger firms** is being reflected in more flexible transition agreements that normally cover interim issues such as partner compensation, equity and capital, assumption of liabilities and commitments, and terms for partners

in the acquired firm seeking short-term succession.

■ **Deals between smaller firms are more acquisitions than mergers.** In these cases, the increased demand from buyers has resulted in some upward pressure on valuations compared to several years ago. Multiples are higher, and buyers are more flexible with operational transition such as assumption of leases.

Joel Sinkin (jsinkin@transitionadvisors.com) and Terrence Putney (tputney@transitionadvisors.com) are partners in Accounting Transition Advisors LLC.

To comment on this article or to suggest an idea for another article, contact Joanna Overcash, senior editor, at lovercash@aicpa.org or 919-402-4462.

process now while the sellers' market is still favorable.

FUTURE OPPORTUNITIES FOR SMALL FIRMS

The primary demand for acquisition of small firms (three or fewer partners) has traditionally come from midsize firms seeking top-line growth. Many midsize firms have inconsistent practice development tactics and depend on acquisitions for their long-term viability. The key issue for small firms seeking succession solutions is their prox-

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Firms in larger metro areas tend to see higher valuations than those in smaller areas due to higher competition between potential suitors. The economy has enhanced the demand for acquisition of these firms; that demand is not expected to abate any time soon. Three main factors underpin the robust market for smaller firms:

1. Most markets have a significant number of firms large enough to acquire smaller firms. This creates an ongoing active demand and competition between potential acquirers.
2. Smaller firms often have limited resources. The choice of expensive and inconsistent organic growth through traditional practice development, or growing "one client at a time," is not seen by many firms as an attractive approach compared to acquiring other firms their size or smaller, a tactic which can create instant growth of 10% to 50%.
3. Small firms are often easy to absorb. A small firm can often be integrated with little to no increases in infrastructure, leading to high incremental profit margins for the acquirer. Additionally, the deal terms usually are structured so that the firm can be

WHAT ARE THE TRENDS IN VALUATIONS?

Demand for M&As has recently increased, as have valuations. Mergers between large firms are normally structured through the admission of partners in the smaller firm using the terms of the larger firm's partnership agreement. Normally, a transition agreement covers interim issues such as partner compensation, equity and capital,

assumption of liabilities and commitments, and terms for partners in the acquired firm seeking short-term succession. We are seeing much more flexibility recently from larger acquiring firms in these transition agreements to get these deals closed. This reflects the greater competition and appetite for mergers within the larger firms that are engaging in M&As nationally.

The same is true for mergers between smaller firms. In addition, many deals between smaller firms are more acquisitions than mergers. In these cases, the increased demand from buyers has resulted in some upward pressure on valuations compared to several years ago. Multiples are higher, and buyers are more flexible with operational transition such as assumption of leases. However, although this trend was more evident in the latter part of 2009 through the first part of 2010, we are seeing a softening again in valuations and terms, and attribute this to a significant increase in the number of firms seeking upstream mergers and sales. The economy has clearly affected terms required by buyers in two specific areas:

1. **Longer retention periods.** Buyers are less willing to acquire a firm based on a fixed value only to risk that acquired clients will go out of business or otherwise decrease the fees they pay for services. Thus buyers are seeking longer periods for retention

adjustments in the purchase payments. More and more deals are being based solely on collections from acquired clients for longer periods.

2. **Emphasis on terms creating positive cash flow for the buyer.** This comes in the form of little to no down payment and purchase payments that are financed out of the cash flow generated by the seller's profits (previously the seller's partner compensation). The impetuses for this are:

- a. Diminished operational cash flow: Many buyer and seller firms are experiencing poor collections.
- b. Credit markets are tight: Buyer firms often have limited access to external capital to finance purchase payments and working capital.

As a result, buyer firms are more frequently structuring deals so they can be financed internally through the incremental profits generated by the acquired firm's practice. ❖

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"A 2009 Tuneup for Your Firm's Succession Planning," March 2009, page 42

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