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The Effect Private Equity is Having on Value/Deal Structure of CPA Firm M&A

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expert support to help you grow your CPA firm



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Most Popular 3 Questions We Get?

What's the Multiple?

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So, what are practices going for?

Value depends on

- Unique characteristics of the practice
- Who the buyer is
- Why the buyer is interested



What's Driving M &A Activity?

Overall inability to provide succession for partners

Baby Boom Generation still in control

Lack of talent

Lack of skills to develop new generation of leaders

Lack of confidence by retiring partners they will get paid

Lack of confidence by succeeding partners they can afford to pay



What's Driving M &A Activity?

Increasingly expensive and complicated technology

Competitive pressure from larger firms going downstream

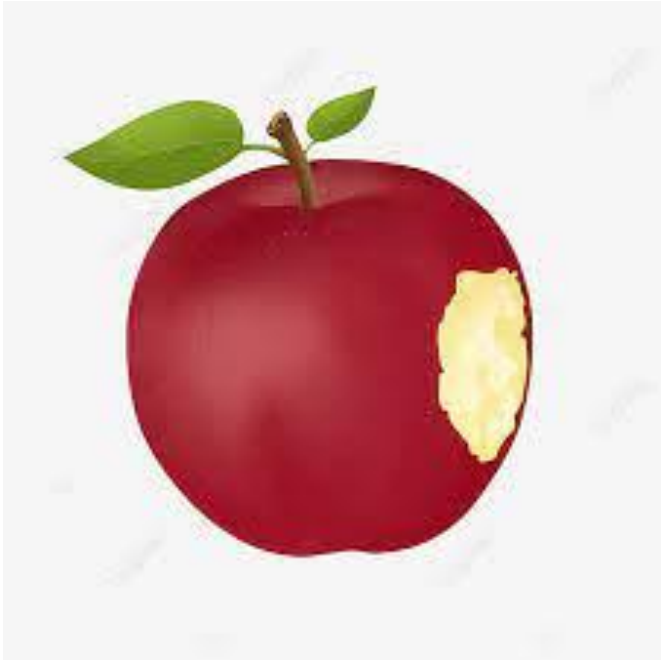
Trends in the industry to eliminate or de-emphasize compliance services



New Buyers in the Marketplace

New entrants from private equity offer:

- An opportunity to monetize the firm's value
- Capital to spur extraordinary growth
- Ongoing participation in value enhancement
- A second bite of the apple…….for some a third and fourth bite



Traditional Approaches to Acquisitions

Traditional Purchase/Sale transactions

- Acquisitions result in no new owners admitted to successor firm
- Value often determined on a multiple of revenues
- Down payments from 0% to 20%



Traditional Approaches to Acquisitions

Traditional Purchase/Sale transactions

- Payments contingent on client retention
- Payments made over 5 to 10 years
- Often treated as deferred compensation
- If seller stays on in a full-time role, payments delayed



Traditional Approaches to Acquisitions

Traditional Purchase/Sale transactions

- Valuations recently trending down to 65% to 100% of revenues
- Buyers asking to retain AR and WIP for 1 to 2 years following the acquisition…even permanently
- Term of payments trending longer



Traditional Approaches to Acquisitions

Traditional Purchase/Sale transactions

- Emphasis on client base
- Buying revenue-easier than one client at a time organically
- More focus on the quality/fit of client base with more firms available



Traditional Approaches to Mergers

Mergers v sales

- Merging partners exchange ownership interest in their firm
- Sign on to successor firm owner agreement
- Often given up to 2-year conditional guarantee of compensation
- Required to make a capital contribution-often can use capital in their existing firm



Traditional Approaches to Mergers

Eventual value of their firm is captured when they retire

Valuations run from 65% to 80% (if equity based) or 2 to 3 times compensation

Usually paid over 10 years as deferred compensation



Vast majority of M & A deals in the accounting space are still being done the traditional way

Motivations to Structure the Traditional Way

Buyer firms unwilling to commit capital

Most buyers oppose third-party debt

Minimizing the financial risk

Shift the risk to the seller

Won't invest in more intense due diligence/don't trust it

Internal politics of internal retirement buyouts



Private Equity's Response

We've got a much better way

We have and will invest capital in the deal

We can manage the risk through due diligence

We are creating a partnership with the acquired firm

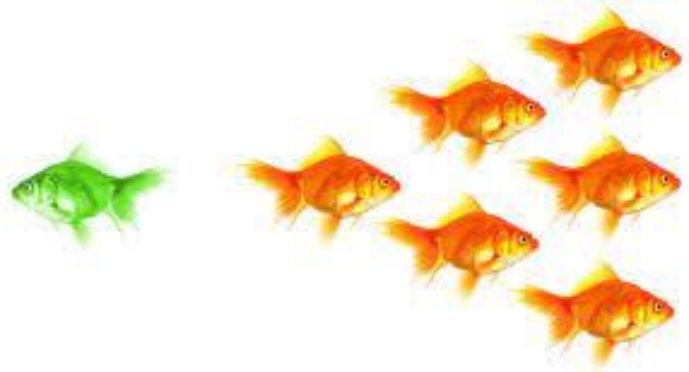


Private Equity's Response

We aren't burdened by how it's always been done

We can drive extraordinary growth with more capital, risk tolerance, expertise

We know how to create and capture value



Basic Alternative Practice Model

Acquiring firm not a CPA firm

Cannot own a CPA firm providing attest services

Break off the attest work from other services

Attest work typically less than 40%, often less than 20%

CPAs own and operate the attest firm, non-CPA buyer owns and operates a separate firm

Go to market with a seamless service offering



Basic Alternative Practice Model

Consolidator model

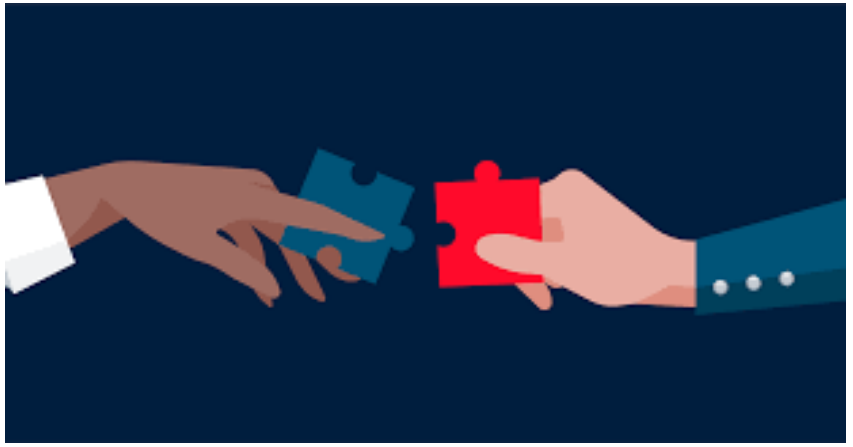
- Operated two separate firms in form…but
- The two firms operated economically as one in substance
- Compensation of the partners determined in combined pool



Basic Alternative Practice Model

Private equity model

- Maintain more entrepreneurial approach
- Keep the partners incentivized for the entire service offering
- More of a true partnership rather than a top-down management structure



Previous Attempts-The Consolidators

Active from 1990 through 2010

American Express, CBIZ, H & R Block

CBIZ survives

Many similarities to the current approaches to PE

Key differences based on the learnings of what didn't work



Consolidator Model

Create EBITDA with a compensation haircut-35% to 40%

Buy 100% of the firm

Purchase payments start immediately

Used seller financing of up to 5 years

Asset deals versus deferred compensation

Consolidator Model-What Went Wrong

Entrepreneurial partners converted to employees

Only future upside was in the compensation

Substantial growth required to overcome the “haircut”-never materialized

In the case of AMEX and HRB the accounting divisions never lived up to the core business already in place



What is Private Equity Doing Different?

The same concept of compensation adjustment to create EBITDA

Flexible on the haircut

Willing to consider some upside potential-not just relying on historical results

Not acquiring 100%-keeping the partners in the game

What is Private Equity Doing Different?

Willing to commit much more capital to the deal-in some cases all the purchase upfront

Building business plans to drive growth

Will deliver ongoing stream of capital to drive growth

Looking for extraordinary ROI that will be shared with CPA firm

Emphasis on what the deal means to young leaders



Private Equity Valuations

Any reference to revenue multiples is only packaging

Deals based on EBITDA multiples

Consolidators generally were up to 6X EBITDA

Current PE valuations are 6X to 10X EBITDA and even higher for advisory practices

Expected secondary transaction in 3 - 5+ years to capture even greater value for the partners

Maybe a second, third, or fourth round of monetization

Impact of PE On the non-PE Market

Small tax/accounting firms

- Business as usual
- Declining valuations as supply increases and demand declines
- Multiple range in 65% to 115%
- Highest multiples found in largest metro areas
- Higher multiples usually require longer payout periods and tax treatment favorable to buyer



Impact of PE On the non-PE Market

Larger firms relevant to PE market

Non-PE acquirers becoming more competitive

- More deals structured as an acquisition
- Larger upfront payments
- Higher multiples
- Shorter retention adjustment periods
- More favorable tax treatment
- Payment periods don’t seem to be affected



Summary

Valuations of traditional and smaller firms trending lower

Valuations of specialty firms and larger firms trending higher

First firm acquired by new P/E entrant will command a premium

More aggressive terms apply to more than pricing….all terms of the deal



Questions?

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