



M&A foretold

The need for succession security, client growth and staff talent continues to drive the desire for mergers and acquisitions.

By Joel Sinkin and Terrence Putney, CPA

MERGERS AND ACQUISITIONS IN RECENT YEARS HAVE HIT

unprecedented levels. But what are the reasons behind the M&A explosion, and what will the market look like in the near future?

A variety of factors have come together to create a strong demand for upstream mergers or sales. For one, many accountants find that competition within the marketplace makes practice development increasingly challenging. Growing one client at a time is a difficult way for many firms to break even, let alone expand. A merger or acquisition, in this case, is a viable option for quick growth.

Furthermore, technology advances have created new opportunities within the accounting profession. They have also caused many traditional services to become obsolete. To compete, many firms have added specialty services to their practices, including investment advisory services, IT consulting, litigation support, valuations and specialized tax services. Merging or acquiring another firm is one way to obtain the necessary expertise to offer these new niche services. It also creates access to clients that may use the specialty services a firm already offers.

Another factor contributing to the heightened demand for M&As is the difficulty in finding and developing staff. Although most accounting firms continue to be valued according to the size of their client base, staff is also often coveted by acquirers.

Partly because of staffing shortages, particularly within the ranks of professionals near partner level, many firms lack the necessary talent to create a viable internal succession strategy. A merger or acquisition will either create an instant solution or add the talent necessary to prepare a long-term answer.

Accounting firm owner demographics come into play here. For example, from 1993 to 2004, the percentage of AICPA members younger than 40 decreased from 53 percent to only 32 percent. Fifty-six percent of firms recently surveyed by the PCPS indicated that at least one partner will retire within 5 years. The vast majority of accounting firms have three or fewer partners, and the loss of one partner often means the need to sell or merge the firm. Furthermore, 27 percent of firms have partners who are 63 or older. These partners own 30 percent or more of the firm.

Because of this, many industry futurists foretell a glut of sellers on the market. Many predict that valuations will drop, and that some firms will feel the challenge of finding prospective buyers. However, the scenario may not be so dire for firms in larger metropolitan areas, and with less than \$1 million in annual fees.

Firstly, in markets like Chicago, the ratio of buyers interested in acquiring firms smaller than \$1 million in annual fees is probably more than 8-to-1. A significant drop in that ratio will result in a seller's market, however. Firms in the \$1 million to \$10 million range are growing in size, and the partners of those firms are managing larger books of business due to technology and practice management improvements. These are the most common buyers of firms under \$1 million.

Many smaller firms are acquired by firms that don't necessarily need to add new partners to manage the increased client load, but rather wish to acquire clients and staff quickly. More and more, we're seeing firms using mergers and acquisitions to assure steady growth.

Some trends in the M&A marketplace are impacting firms with succession needs. Firms in more rural areas, for example, have always found it more difficult to find potential buyers. The demographic trends do and will continue to have a greater negative impact on these firms. Also, activity amongst consolidators has slowed tremendously since 2000. As a result, large firms are much less likely to sell in a transaction that will create liquidity for the owners. They are much more interested than they were five years ago in merging in partner-level talent with long-term career aspirations versus acquiring clients for pure growth.

Firms in excess of \$1 million, and particularly those in excess of \$5 million, naturally have fewer potential firms with which to merge or sell. There are roughly nine times as many firms in the profession that are under \$1 million in size compared to those over \$1 million. The age demographics of accounting firm partners and other factors in the marketplace mean that succession planning for firms in excess of \$1 million will continue to be difficult.

What can firms do to better position themselves for future succession planning and the effects of emerging market trends?

Transition clients and staff. Buyer firms and those seeking mergers will have more choices of firms from which to select, as the Baby Boomer generation continues to age. They will be seeking practices that are running efficiently and whose clients and staff can be transitioned smoothly. Partners of firms that take the position that, "No one can retain my clients if I'm not here," are providing an argument for why their practice has less value. Firms with clients loyal to their brand, staff, etc., make the likelihood of the successor firm retaining clients higher, therefore increasing their value and the number of firms interested in acquiring them.

Develop higher value services. Firms with skills and talent other than pure compliance are likely to be more attractive to acquirers, especially as the size of the firm increases. However, this is a double-edged sword. Compatibility with the existing service offerings and client base is often required to put a successful merger together.

Plan in advance. The viability of the internal succession team should be addressed as much as 10 years before the firm starts the buy-out process. The process for finding the “right” external solution should be considered at least 5 years before the solution is actually required. There are ways to put external solutions in place without outright sales prior to partner retirement. Clients and staff transition better if they are prepared for partner retirement many years in advance of the event.

It’s not just a matter of evaluating a merger or acquisition as a means to grow. It’s a matter of understanding the market of today and tomorrow well enough to know how attractive you are as an M&A candidate—and how feasible this strategic move really is. □

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