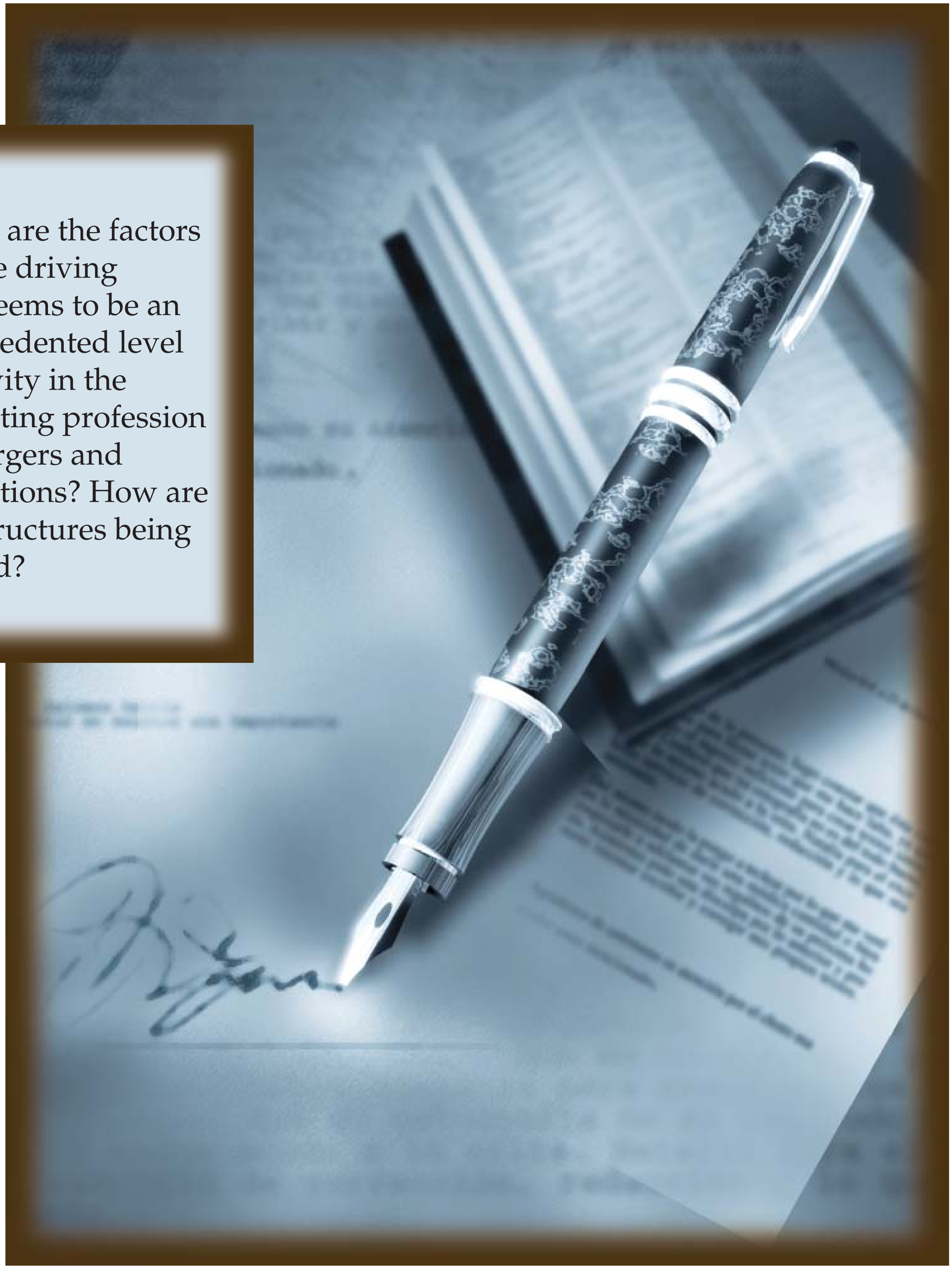
Understanding the Market for Accounting Firm Mergers and Acquisitions

by Joel Sinkin & Terrence Putney CPA

What are the factors that are driving what seems to be an unprecedented level of activity in the accounting profession for mergers and acquisitions? How are deal structures being affected?



There is no doubt that there are many more mergers and acquisitions of accounting firms in the news these days. Some of this is due to the number of outlets for news and the Internet. Even though most of this activity is not announced publicly, there is a clearly a significant increase in the number of practitioners that are seeking succession solutions through a merger or a sale of their practice. A significant number of firms are also including mergers and acquisitions as a major component of their growth strategy.

Forces driving the supply and demand for M & A

There are several factors that have changed in the accounting profession that are driving this activity. Those include:

- **Staffing shortages**
  The profession has for several years been short of staff. Smaller practitioners seeking a sale of their practice or an upward merger are sometimes driven to do so by an inability to attract the staff required to even maintain their client base, or a fear they will face that problem in the near future. Larger firms often seek a merger or acquisition looking for quality staff, particularly partner and near partner level staff.
- **Practice Development**
  The level of competition both within and outside the profession can be daunting. Practice development efforts can be expensive, time consuming and many practitioners do not relish the prospects of spending a significant amount of their time growing their practice one client at a time. A merger or acquisition can lead to adding hundreds of clients all at once and much quicker growth. Smaller firms sometimes fear losing a portion of their client base to competition and seek a merger to alleviate this risk. Examples are firms that have concentrations of clients in certain industries like medical services or that have one or two clients that make up a significant portion of the practice.
- **Demographics**
  The accounting industry has and continues to age. From 1993 to 2004 the percentage of AICPA members younger than 40 decreased from 53 percent to 32 percent. Twenty-seven percent of firms have partners 63 years old or older that also own 30 percent or more of the firm. Until recently the profession failed to attract young talent starting in the late 1980's. This has translated to a lack of internal succession candidates. Many firms have no alternative but to sell or merge to achieve succession and provide for the retirement of their owners.

Prospects for firms seeking a sale or upstream merger

The factors that most affect a firm's ability to find an external succession solution and firm value are:

- Size of the market the firm is located in
- Size of the firm
- Types of clients the firm serves
- Staff available after the affiliation and the transition plan for the owners

Firms in larger metropolitan areas have always found it easier to find a firm to merge into or acquire their practice than firms in smaller markets. This discrepancy in demand also affects the value the firm will have in a transaction.

Because there is such a diversity of firms that are seeking mergers and acquisitions as a means of growing their practice, the impact of the size of the firm seeking succession can be surprising. A $3 million firm is very attractive to a larger firm. The problem is there are many fewer firms that are able to merge in or acquire a $3 million firm than a $500,000 firm. The sweet spot relative to size tends to fall in the $150,000 to $1 million range in annual fees. The combination of the types of clients, services offered, and the number of firms interested in a deal with this size firms makes them the most sought after. Firms outside this range still have options but may find valuations lower and have more difficulty finding a successor.

The owner's transition plans can have a significant impact on value as well. This is for two reasons. The ability to transition client relationships is the key to creating value for both parties to the transaction. The longer the clients of the predecessor firm have to become acclimated to the successor with their existing contact person in place, the more likely the clients are to transition successfully. Plus, the owner of the firm is normally the most key and talented staff person in the firm. The most successful mergers and acquisitions are the ones where the owners of the acquired firm stay on for a time after the affiliation. Generally, two to five years is the optimum time for a practitioner to remain involved in the practice to achieve the best results for both firms.

Types of transactions in today's market

The following types of deals make up the majority in today's market:

- Outright sales
- Mergers
- Two Stage Deals
- Cull out sales

In an outright sale, the owner of the firm being acquired normally turns over the practice to the buyer immediately and stays involved for a short period of time only to help in the transition. In some cases, the owner might be employed in the role of an experienced staff or non-equity partner. The buy out payments for the practice normally start immediately.

A merger is often an exchange of the equity interests in one firm for the equity of the other firm or a newly combined firm. Normally, most of the partners of both firms become partners in the newly combined firm. The buy out of equity is often handled through buy-sell agreements or partnership agreements that are designed to provide retirement benefits.

A Two Stage Deal is a technique that uses features of both a buy out and a merger to address the unique needs of both parties in a specific situation. In a Two Stage Deal the owner of the firm seeking succession remains in control of the clients and continues to work with the clients full time or near full time for an agreed upon time frame. The owner's compensation is maintained at historical levels as long as the client base remains intact and the acquiring firm doesn't incur additional costs to provide back up and support. Then, at the earlier of the owner's discretion or at an agreed upon date (normally five or fewer years) the owner leaves or slows down to a part time role and the buy out commences on terms that were agreed to at the beginning of the affiliation. See Two Stage Deals published in the March, 2006 issue of the Journal of Accountancy by the authors for more details.

Due the demographic issues many multiple partner firms face, it is not unusual for firms to have partners that are primarily interested in being bought out now or in a few years while other partners seek to extend their careers for a longer period or even indefinitely. A popular technique in these situations is to design a Two Stage Deal type of transition for the partners seeking near term succession and a merger type of transition for the other partners.

A cull-out sale involves segmenting a portion of the practice and selling it off. Examples are certain services, groups of clients, or an office. Normally, the sale is designed as an outright sale because the seller desires to cease providing services to a portion of the practice. Often, though, an ongoing relationship between the buyer and seller emerges if certain services will continue to be provided by the seller to the former clients. A popular scenario where this type of transition applies is a practitioner that wants to focus on financial services and seeks to sell the compliance portion of the client relationships to another firm.

Valuations for accounting firms in today's market

As stated earlier in this article the price for a firm will be affected by the size of the market the seller operates in, size of the firm, the types of clients, and other intangibles such as staff and office lease issues. However, the number one factor in today's market that affects the price of any specific firm is the terms of the deal itself. The terms of a deal interact with each other to determine the price which is normally expressed as a multiple of annual fees. The four primary terms to be considered are:

- Down payment at closing or at the commencement of the buy out
- Number of years payments are made over (assuming no interest is paid on the deferred payments which continues to prevail as the most common approach)
- To what extent and for how long the payments are determined based on client retention
- Tax treatment (current deduction versus intangibles amortization for the buyer) as well as other factors affecting the buyer's profitability from the deal

The more the above terms favor the buyer (e.g., little or nothing down, pay out periods of five years or longer, pricing dependent entirely on client retention for up to the entire pay out period, and a current deduction for the payments), the higher the multiple of revenues buyers should be willing to offer. The opposite is also true. Terms that require a lot of cash up front, that require the buyer to accept significant risk for lost clients, and that require the deal be deducted over 15 years will tend to result in a low multiple in today's market.

Conclusion

The market for firms seeking succession through a merger or sale remains very active. Despite predictions of a glut of sellers creating few opportunities for practitioners seeking succession, the number of firms seeking to grow through mergers and acquisitions is increasing. However, in order to assure success, practitioners and firms that are five or fewer years away from wanting to substantially slow down or retire should consider acting now to promote the proper transition of client relationships and maximize value.

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