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Voices Accounting firm M&A in the world of the coronavirus

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The economic downturn we are experiencing is clearly unprecedented. The projected drop in the GDP and level of unemployment are anticipated to be as bad as the Great Depression. It would be logical to project with the amount of uncertainty we are facing that merger and acquisition activity amongst CPA firms will grind to a halt. Much of the messaging about M&A within other industry segments would support that notion.

However, we have two very recent similar economic events to draw insights from: 9/11 and the financial market meltdown from 2008-2010. Although many accounting firms suffered from no growth and even revenue declines, especially in 2008-2010, M&A activity turned out to be even a little more robust than in the period just prior to 2008. This is consistent with what we have seen over the 30 years we have been consulting with accounting firms on growth through M&A. When organic growth slows down, M&A activity increases.

Until we see the stay-at-home and social distancing guidelines most of the country is under relax, it will be very difficult to complete any deals that are in process already, and unlikely many new deals will be launched. Assuming those restrictions are lifted sometime in mid-summer, we think deal activity will pick up quickly, though. Our experience in the above-mentioned recent economic downturns and conversations we've had with some of our clients are informing our opinions about what we think could happen during the rest of 2020 and into 2021.

Buyer attitudes

We see two schools of thought foretelling buyer attitudes. There will be a significant number of firms that have previously been active with acquisitions that will sit back and wait for a more certain economic climate before becoming active again. Many firms, especially larger ones, have recently been much more strategic with identifying M&A targets. It can be hard to execute against a long-term strategy when there are so many unknowns. Some of those firms have told us they are on hold for now. We've already seen layoffs and compensation cuts announced at some of the largest firms in the profession. Of course, we are talking about accountants and it is not unreasonable to expect many firms to just be generally cautious.

However, we know that many midsized firms that tend to be more tactical with M&A will see this environment as full of opportunities. Like the adage that Wall Street climbs a wall of worry, we believe many firms will be motivated to seize the moment. We saw that in 2008 as well.

Seller attitudes

Many partners seeking to sell or merge up are motivated to lock in their retirement through an external solution that is better than what they can do internally. Our initial reaction to this situation was that the significant drop in the stock market would cause those partners with near-term retirement in mind to wait for their other retirement assets to recover before pursuing a sale or merger. So far, based on what we have seen to date, this is not the case.

Firm owners that are near a projected retirement date appear to be motivated to create a much safer future for themselves by merging now. Even deals that are designed to create a near-term liquidating event usually include a period upfront where the selling partners work for a while during transition. So, it is likely the economy will recover while they are still working at the firm into which they have merged or sold. Combining with a larger firm with more resources and the ability to weather this storm seems to make sense not only to partners nearing retirement, but also their partners who might not be as confident they will be in a position to pay them out without help.

Will it be a buyer's or seller's marketplace?

In recent years, the market for mergers has clearly shifted to one that favors buyers. It is a matter of supply and demand. The supply of sellers has overwhelmed the demand from buyers, mostly due to demographics. Some buyers have so many opportunities to choose from that they can be very picky.

What we saw in 2008-2010 may seem counterintuitive but is instructive. Back then, because M&A was almost the only way most firms could grow, firms became hungry for deals to promote growth. For a while, the market shifted to more of a seller's market. It is too early to say that will happen again, but it is not out of the realm of possibility, especially with regard to smaller firms. The difference now from 2008 is not only are we still in a market with lots of sellers due to succession issues — probably more so than in 2008 — but we also may have more motivated sellers due to economic uncertainty.

Deal terms

A pure merger normally uses the successor firm's owner agreement to dictate the terms for the partners merging upstream. Therefore, we don't expect there to be much change in the way pure mergers are structured due to a downturn in the economy. However, many mergers include a near-term buyout for some merging partners and, of course, many deals are done as a purchase and sale. The terms for those deals are likely to be affected by the coronavirus economy.

Like 2008, accounting firms expect to see slower payment for fees overall. Many buyer firms are opposed to borrowing and often negotiate deal terms to minimize external financing. We expect buyers to be less inclined to pay down payments. We also expect buyers to request to use the seller's receivables for a time to help finance the upfront costs. We also expect the trend toward longer payout periods to continue.

Virtually every purchase transaction has some form of lookback based on retention of a seller's clients by the buyer. We believe the perceived risk of clients going out of business and moving their accounting relationship due to economic pressures is likely to put more emphasis on lookback adjustments. If a transaction previously might have included a two-year lookback, the same buyer might ask for a longer retention period now.

The 2008 downturn created excess capacity for many buyer firms. We expect the same is likely to be the case again. Buyers that are in that situation tend to be more aggressive about finding and closing deals because acquisitions become more incrementally profitable. The flip side of that is that buyers with excess capacity often try to avoid taking on more capacity in the form of a new office from a seller firm. Additionally, most firms have a newfound appreciation for mobile workforces in the past few weeks. If that leads to a permanent change in the way firms create workspaces, assume a seller's lease may not make as much sense as buyer firms downsize their office space.

The question that is always on the minds of both sellers and buyers is, "What is the multiple?" The shift to a buyer's market in recent years has driven down multiples across the country. Whereas a multiple above one times revenue was common in the largest metro areas five or more years ago, that is rare today. However, what is not so widely known is when a buyer is highly motivated to close a deal with a specific firm, they will often find a way to offer an above-average multiple to get the deal done. One approach that is commonly used to justify a higher multiple is to lengthen the payout period, which creates better cash flow. We believe the buyer firms that are highly motivated, now for reasons other than just achieving certain strategic objectives, will stay aggressive even during this economic downturn.

It seems logical that in a down market prices should drop. The real estate market has shown that, in certain circumstances, the market seems to have no bottom. However, we believe that multiples have already adjusted downward far enough that trying to squeeze a few more percent of multiple out of a deal won't justify losing the opportunity. We think multiples are likely to at least hold at current levels.

Compliance versus consulting

The message that the profession needs to move away from compliance services to advisory and consulting appears to have gotten through loud and clear. Many of the larger firms active in M&A have recently avoided acquiring firms with mostly compliance-based practices. The irony is, when you consider what is likely to be the revenue an accounting firm can count on in a down economy, it is compliance services.

Many firms have told us they aren't worried. People and businesses will still need to file tax returns. They will still need an audit. Certain consulting services will be in higher demand now. The cybersecurity firms we have been in contact with tell us they can't keep up with the demand. Other consulting might be considered discretionary by clients and at least delayed. Will this downturn change buyer attitudes toward acquiring compliance-based practices? Hard to say, but at least it's a possibility.