Trends in M & A of CPA Firms Including the Coronavirus Impact

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Transition Advisors

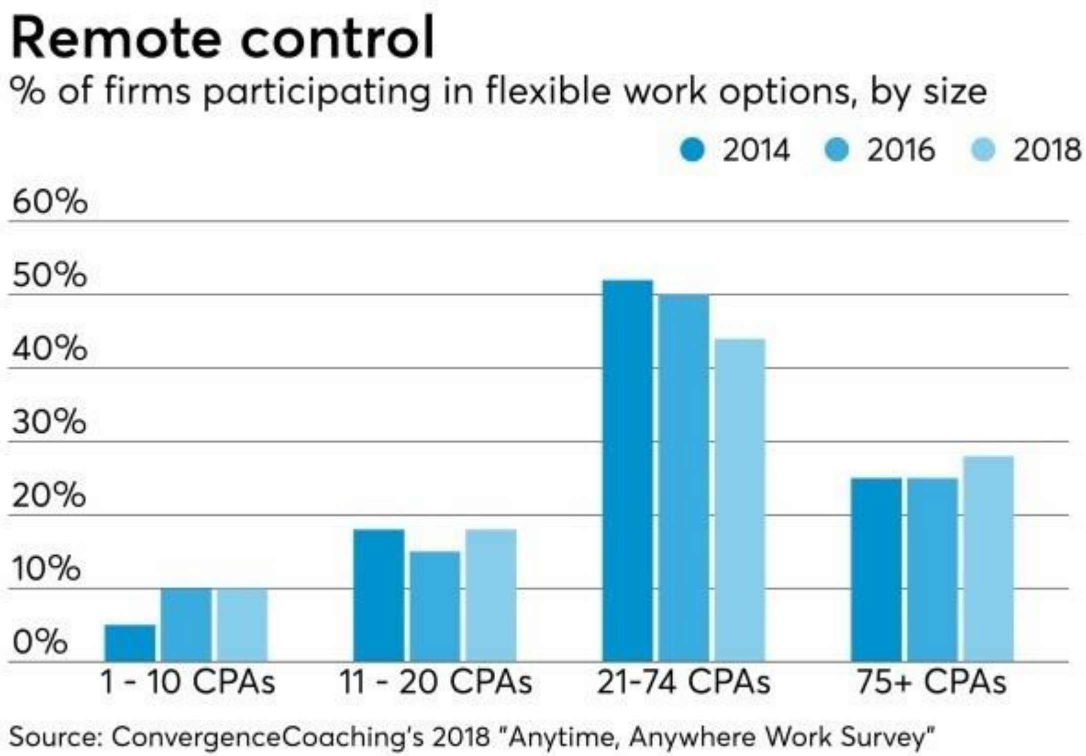
National Consulting Firm working exclusively with accounting firms on issues related to ownership transition

DEAL FACILITATION
Searches
Introductions
Negotiations

TRANSACTION SUPPORT
Contract Design/Review
Due Diligence Support
Deal Structure
Valuations

PRACTICE MANAGEMENT
Transition Planning/Implementation
Succession Planning
Compensation Plans
Partner Agreements

This is not your father's CPA firm!
Before the Pandemic



Owner/Partner Succession

* Nearly 80 percent of firms in the PCPS Survey expect succession planning to be a significant issue over the next 10 years.

Why it takes longer to transition many clients in 2020 then it did in 2000?
When to start the process?

It takes a minimum of 3-5 years to implement the necessary changes to ensure a smooth transition of clients and staff. Succession planning should begin 5-7 years out.

** AICPA PCPS Survey of 6,400 firms*

Will it be a buyers' or sellers' marketplace?

All about supply and demand

Prior to Coronavirus Economy-

Sellers were outstripping buyers in many cases

Trend was clearly to a buyer's market

Result was more selective buyers and tighter terms

Will it be a buyers' or sellers' marketplace?

All about supply and demand

In the Coronavirus Economy…

Overall we see a shift to a more balanced market

Small sellers in high population areas

Niches still likely to get premium

Big firms still face limited buyer pool

Will it be a buyers’ or sellers’ marketplace?

In 2008-

Firms could not depend on organic growth in a flat economy…and

Therefore…

M &A became the option to maintain growth

Expect a significant uptick in deal activity as a result once vaccine is in place

Will it be a buyers' or sellers' marketplace?

In the Coronavirus Economy…

Some buyers will hunker down

Some buyers will ramp up to increase lost revenues

Savvy buyers will see the opportunity to do deals in a "down market"

Therefore…

Demand side will overall improve

Will it be a buyers' or sellers' marketplace?

In the Coronavirus Economy…

Some sellers will delay due to the stock market

Other sellers…will see risk due to sudden decrease in fees

Poor succession plans…will continue to drive M & A and niches

Overall we see the supply side of the equation remaining a push

What Will Happen to Firm Valuations?

What drives valuations?...

Terms

Firm characteristics

Cash Investment Upfront

Cash investment upfront in a sale includes…

- Often buyer required to invest up to 25% of seller's volume to replace working capital
- Average of about 10% for incidental costs like moving, marketing, technology upgrades
- Down payments have recently ranged from 0% to 20%
- Other soft costs (mentoring programs…)for training and lost productivity during transition

Cash Investment Upfront

In the Coronavirus Economy…

Buyers are likely to be strapped for cash due to slower paying clients and rising A/R and likely will be:

- Less inclined to make down payments
- More inclined to request use of seller's working capital with payback over 1 to 5 years
- Push for other terms that stretch out the payments
- PPP work and other virus-related programs may help offset some of these issues for some firms but temporary.

Retention Clauses

In the Coronavirus Economy…

Seller's clients more at risk for loss due to business closings and fee reduction

Future revenues less predictable

Therefore….

- Buyers likely to request longer retention periods (although more than 5 years is unlikely)
- More collection deals
- Economy clauses-retention extended only in the case of a client closing or selling

Multiple

Generally, multiple is the result of the other four variables

- Cause vs effect
  - Multiple = effect
  - Balance = cause
- Basic rule:
  - Lower down payment, longer payout period
  - Higher profitability, longer guarantees = higher multiple

Multiple

In the Coronavirus Economy…

- Buyers may intuitively expect multiples to come down because of the down economy, *however….*
- In 2008-10 multiples stayed strong because of the demand for practices
- Many firms seek to recoup attrition and current capacity.
- When organic growth slows…

Niche Mergers

Barry Melancon said during a speech at the Accountants Club of America in New York:

"When you look at the top 400 firms, there are record numbers of mergers and acquisition activity of non-CPA firms," he said. "We are seeing those firms having to diversify skill sets and technology platforms and capabilities, and they have been doing that through acquisition of other types of business enterprises to diversify within their own environment. About a third of the mergers and acquisitions that occurred in 2018 actually were non-CPA firm acquisitions by CPA firms."

Niche Mergers

Main types:

- IT which varies
  - Cyber; managing, hardware/software consulting
- Wealth management/financial services
- HR
- Litigation support/forensic
- Many more

Niche Mergers

How to structure:

- Establish base compensation niche partners are currently making
- Guaranty their comp remains steady so long as their revenues and time commitment remain steady
- Key is how to share growth
- Are they partners in firm, separate entity?
- Buyout
- Cash upfront requests
- Likely more interesting to growth-oriented niches than short term sellers

Trend to be a One Firm Culture v. Eat What You Kill

- Eliminates “Lone Ranger” mentality amongst more senior partners.
- Easier to transition clients – usually more than one partner services the client.
- Equity & Comp not directly tied to the book of business
- Doesn’t de-incentivize partners to transition.
- No “my client, your client” silos.
- Must tie in ownership agreement/comp programs
- Hard to merge firms of certain different cultures such as eat what you kill versus one firm client unless someone blinks

Percentage of Firms Moving to a OFC

- From 1-8 FTEs - 22 percent
- 8-16 FTEs – 36 percent
- 16-26 FTEs – 53 percent
- 26-51 FTEs – 61 percent
- 51-101 FTEs – 47 percent
- 101-201 FTEs – 76 percent
- 201-plus FTEs – 62 percent

2018 PCPS Succession Survey expect 2019 higher

The Diminishing Meaning of Equity

- Determine "what does equity mean" in your firm? Most one firm cultures equity diminished to little or no role.
- Impact on M & A
- Be aware of the consequences (usually negative) of too much equity owned by one partner when equity is used to allocate value.
- Does equity affect:
  - Succession
  - Governance
  - Mergers/Sale of a firm
  - Compensation

Retirement

Methods for valuing equity:

- Book of business
- Equity
- Compensation
- Hybrids

Trends: larger firms more likely multiple of comp.

Right Financial Arrangement

Available capital is the retired partner's foregone compensation.

The Litmus Test

Three uses for that capital:

- Pay the retiring partner off.
- Cost of replacing that partner.
- Some upside for the remaining partners for assuming the obligation and the extra work.

Rosenberg Survey

Partner Retirement/Buyout

	2–4 Ptrs	5–7 Ptrs	8–12 Ptrs	13+ Ptrs	2017 Total	2016 Total
Multiple of compensation	34.0%	51.1%	55.0%	54.8%	46.4%	43.6%
Book of business	13.4%	8.7%	6.7%	3.2%	9.3%	9.2%
Ownership percentage	26.8%	17.4%	6.7%	12.9%	17.9%	18.3%
AAV	14.4%	13.0%	18.3%	19.4%	15.4%	18.3%
Fixed	3.1%	2.2%	1.7%	3.2%	2.5%	2.9%
Equal	8.2%	7.6%	11.7%	6.5%	8.6%	7.7%
Firms with no retirement provision	24.2%	5.1%	6.1%	5.9%	13.0%	13.8%

When we use the term "partner retirement/buyout," we are referring to plans in which a retiring partner is paid his/her share of the tangible and intangible value of the firm. These types of plans, which are 95% or more unfunded, are addressed in the above chart.

Mandatory Retirement

The percentage of firms that have mandatory retirement provisions:

	2017	2016	2015
Over $20M	91%	87%	88%
$10–20M	74%	77%	72%
$2–10M	61%	60%	60%
Under $2M	19%	17%	29%

The Rosenberg Survey

Mandatory Retirement Age

- Average age is 66[1]
- 54% use 65, 29% are 66 to 70[2]
- How it impacts M & A
- Surrendering equity

doesn't always mean retiring

* Retirement portfolio

* Redoing deals

[1]Rosenberg [2]PCPS

What We Are Hearing

- Hard to close a deal through zoom
- COVID-19 has been an excuse for firms to get rid of underperformers
- Within firms 100+ FTEs geography has a big effect on response
- All larger firms appear to be cautious in their planning
- Firms are spending a tremendous amount of time making sure they “re-open” their offices safely and efficiently-the level of planning has been impressive
- Firms with strong advisory practices seem to be adapting better
- Seeing layoffs at the largest firms
- Hiring is down significantly
- The next wave of hiring is likely to be contract workers
- New leaders seem to be motivated to take advantage of the opportunities this change in environment is creating
- The market is shifting to reward more flexibility
- This crisis has brought to the surface chinks in the armor of some firms
- PPP loans have been very helpful to firms
- Cash flow is a worry for many firms
- LEASES

What We Are Hearing

The results from the first AICPA pulse survey for firms under $5M in revenue include the below highlights:

- Most firms (85%) have not and do not plan on laying off employees.
- Most firms (85%) do not plan to reduce staff compensation. Those that have or are considering will reduce by less than 10%.
- All firms (100%) are keeping their commitments to new hires who haven’t yet started. They are keeping things as they were or are simply delaying start dates.
- Sixty percent of firms expect ‘work from home’ to be a permanent aspect of their firm going forward.
- Most firms (90%) do not plan to delay paying obligations (rent, lease payments, etc.).

What We Are Hearing

The results from the second AICPA pulse survey for firms under $5M in revenue include the below highlights:

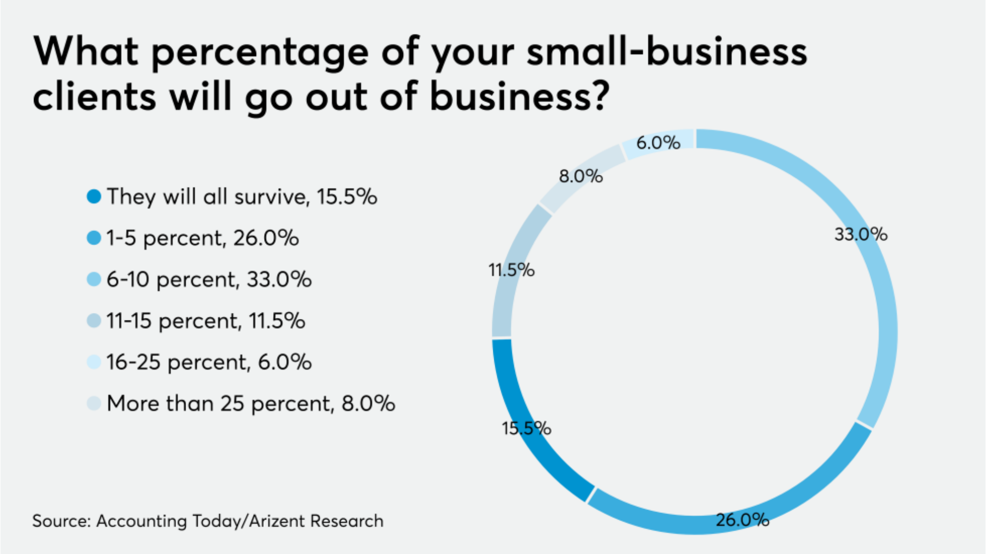
- When comparing May 2020 cash receipts to May 2019:
  - 20% of firms had higher levels
  - 60% of firms had lower levels
  - 20% of firms were virtually the same
- As firms plan for reentry:
  - 40% are implementing physical protection measures (taking temperatures, COVID-19 testing, etc.)
  - 50% are creating workplace environment changes (eliminating workspace sharing, staggered hours, remote work, etc.)
  - 40% are making changes to HR policies (providing increased flexibility, COVID-19 health procedures, etc.)

Accountants see pandemic over by year's end; recovery will take longer

Over half of accountants (56 percent) expect the coronavirus pandemic to end before 2021, and two-fifths of those (42 percent) think it will be wrapped up by the end of September, according to a recent Accounting Today survey.

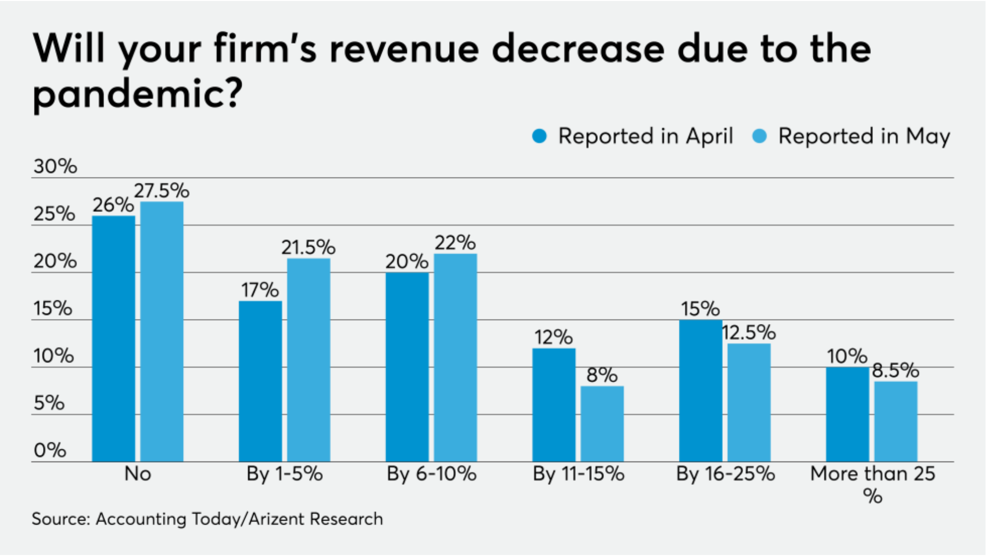
They're less sanguine about the prospects for the economy, however: The AT study, which was conducted in mid-May and sponsored by ADP, found that more than half of the 200 accountants responding (54 percent) don't think it will recover until after the first quarter of 2021. For more details, and other key findings of the survey, see the charts below.

Pandemic



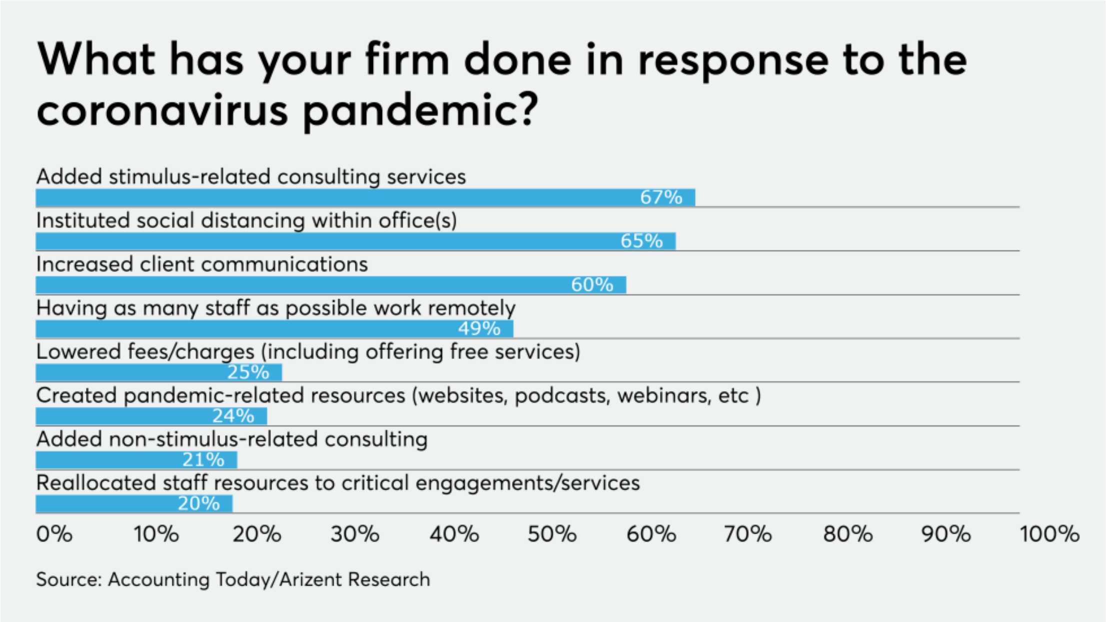
One thing was clear from the survey: The pandemic will be a disaster for small businesses. A third of respondents think that up to 10 percent of their small-business clients will go out of business as a result of the coronavirus, and a quarter think it will be worse than that

Pandemic



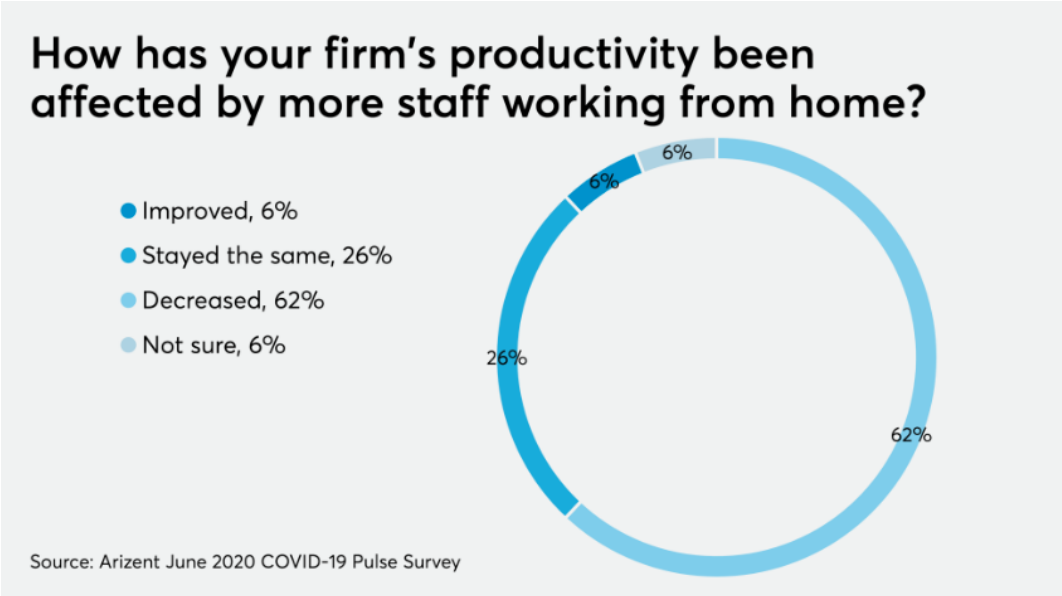
On a more positive note, accountants were slightly less worried about their own firms' revenues in this survey than they were in an earlier survey that was conducted in April. In general, their responses revealed a general, if minor, moderation in their expectations of how much their revenues will decline due to the pandemic. Depends on client base and if PPP types of special fees are being counted

Pandemic



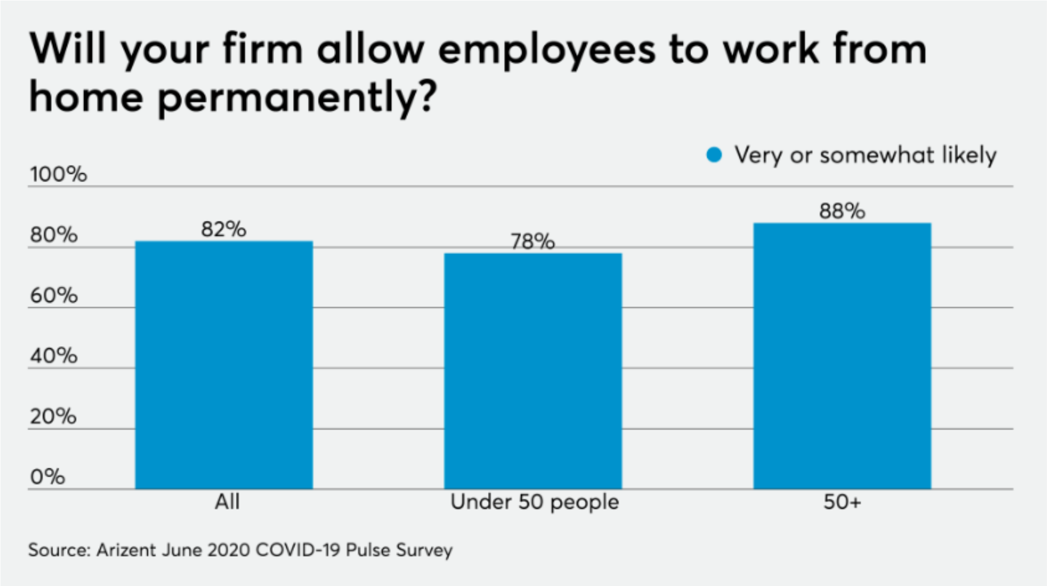
Finally, firms shared their toolkits for responding to the pandemic; interestingly, only 15.5 percent reported they had completely closed their offices, while even fewer (14 percent) said they had laid off or otherwise reduced staff.

Productivity



Regardless of firm size, two-thirds of leaders at practices reported that the greater number of employees working from home had led to a decrease in productivity. Is that an IT issue, management issue, getting accustomed too issue or one to expect to continue

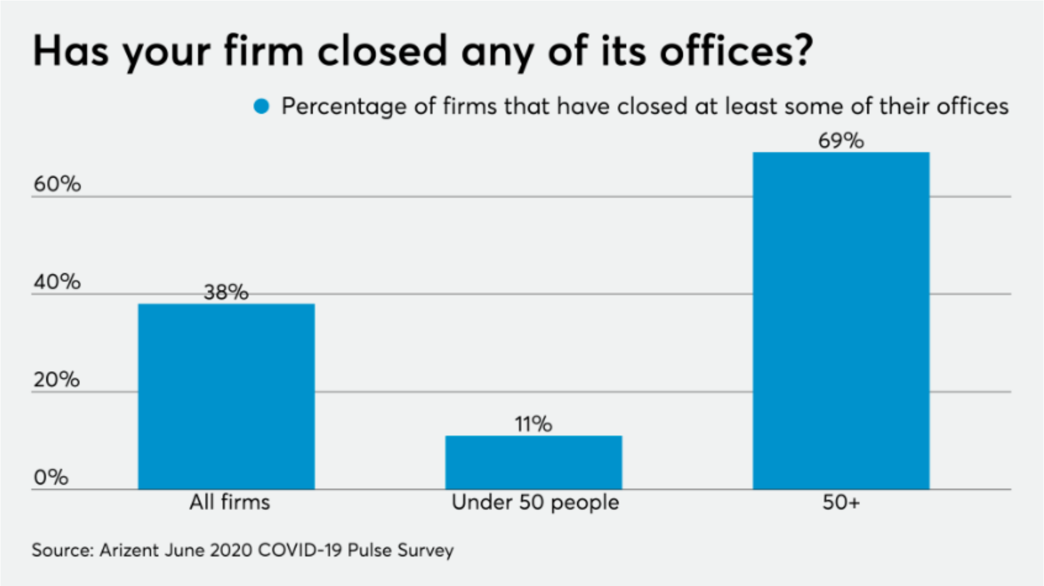
Work From Home



Overall, 82 percent of accounting firms were "very" or "somewhat" likely to allow employees to work remotely even after the pandemic, compared to 73 percent of businesses in the broader survey.

Remote here to stay

Office Closings?



Larger firms were also far more likely to have closed offices or locations; only 11 percent of firms with fewer than 50 staff members reported having closed their offices.

Laying off/furloughing staff & compensation cuts?

According to the website of Going Concern
https://goingconcern.com/tracker-job-cuts-pay-cuts-both-covid-19/

A significant amount of top 100 firms have laid off; furloughed and or reduced partner compensation. Large firms hit hard, not just smaller ones

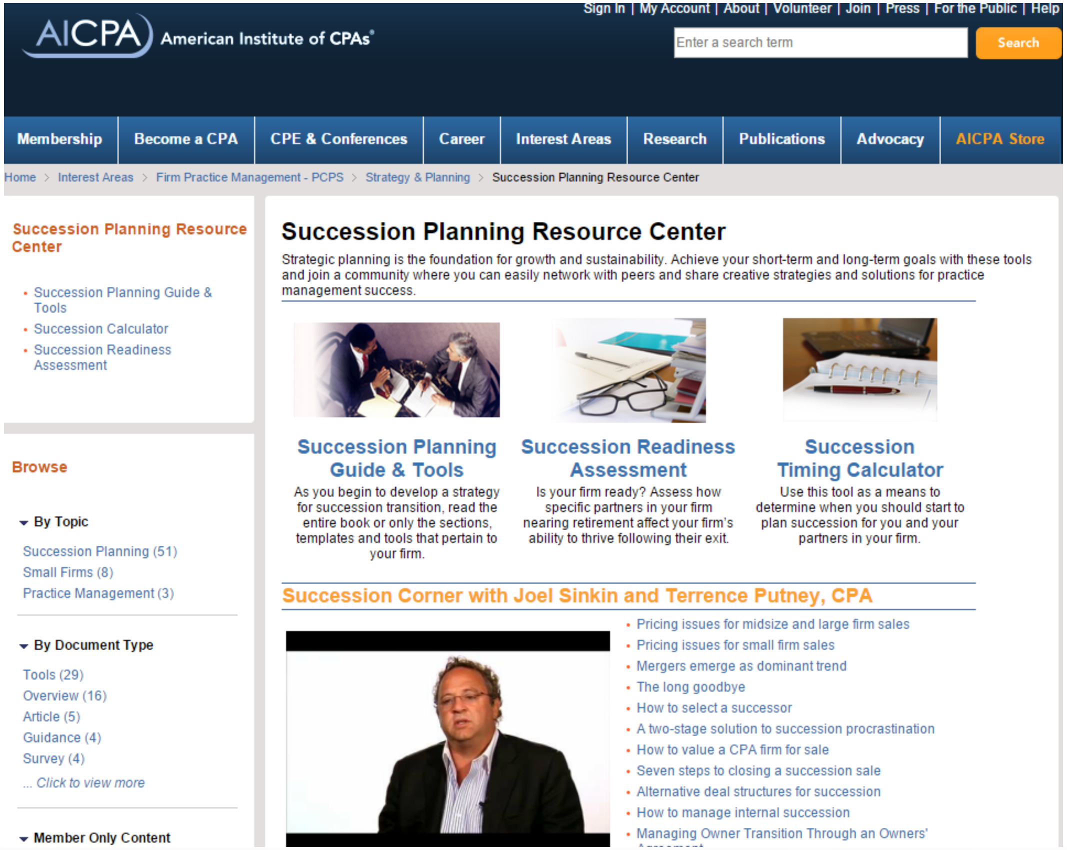
How does increased staffing pool impact small, medium and large firms?

What's next: new stimulus plan generate more services; time will tell who is left standing. One thing likely, more advisory services, less compliance-oriented firms likely safer.

For More Information

Visit the AICPA Succession Planning Resource Center

https://www.aicpa.org/interestareas/privatecompaniespracticesection/strategy-planning/center.html



For More Information

Please visit our website for resources including FREE reports, whitepapers and case studies.

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