Private Equity & You

Is Private Equity Investment in Your Future?

CPATrendlines
FLASH BRIEFING

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1

Key Points to Consider

- Background
- Private Equity Due Diligence
- What are the Trade-Offs?
- What Does the "Plumbing" and Corporate Governance Look Like?
- Is a Private Equity Infusion and Effective Wealth Creation Vehicle for CPA Partners?
- Q & A

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2

Background

- Historically, why have private equity firms found midsized to larger CPA firms somewhat attractive investments:
  - Valuations that are generally low
  - Balance sheets void of heavy debt
  - Generally strong cash flow
  - Clients that are predominantly annuity-based

- As CPA firms slowly transition from the traditional accounting firm compliance model to the more progressive professional services model with a focus on Advisory/Consulting services (higher margin), private equity firms are "droning" for CPA firms to invest in.

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Background con't

- Private equity firms and lenders consider acquiring midsized to larger CPA firms the trailing edge of their investment strategy as CPA firms are not hugely scalable and therefore not in their sweet spot.
- In our view, private equity might hit singles and doubles from an investment in a midmarket CPA firm, but a home run which is what private equity is very attracted to – time will tell.

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PE Due Diligence Generally Involves

Although it varies by size of deal and other factors, the five areas below are generally those areas of CPA firm operations that are included in due diligence process

Due Diligence Focus

CPA firm leadership needs to be prepared to allow a deeper dive into their overall operations than even their bank might do

Information Systems → Cash Flow → Liquidity → Services & Cost of Delivery → Expenses

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Private Equity Due Diligence Process

Information Systems

Private equity firms are numbers driven. As part of due diligence they will expand and mine data that will identify where cash flow is coming from and where it is going. This "professionalization" is viewed as a key tool providing insights that will help in "flipping" their investment in 3 to 5 years

Cash Flow

Although net income is important, private equity firms are fixated on cash flow. They value businesses on EBITDA. Increasing EBITDA is what is going to allow them to eventually cash out for more than they paid.

Expense Control

Private equity firms will dig into all current expenses asking questions about firm policies, controls, expense spikes, etc. For example, partner expense accounts will be scrutinized

Liquidity

Private equity firms use leverage to make investments. Based on that, they will require weekly, monthly and quarterly cash flow forecasts to make sure their portfolio company stays within liquidity covenants and take swift actions if covenants will not be met.

Services & Cost of Delivery

With the objective of determining and improving margins, private equity firms will delve into all services being provided and the cost of service delivery across all areas of the firm. CPA firms often lose track of where they are really making profit and generating cash. Also expect a focus on how new and recurring work is bid with a particular emphasis on avoiding contracts that increase revenue but are not all that profitable.

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What Are the Trade-Offs?

Loss of Independence
Private Equity firm may be "in charge"

Partner Compensation
Initial haircut in partner compensation to create initial cash flow for PE Firm

Culture Change
Often less collegiality and diminished sense of partnership comradery

Firm Leadership
Much greater pressure and oversight of firm leadership to achieve financial and performance goals firmwide

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Difficulties In Cashing Out

How does the private equity firm cash out when it is time to "flip" the investment?

- Not that easy. Mergers into an existing public company, SPACs and IPOs are most common ways that private equity firms exit their investments.
- But history has shown that flipping a professional services firm is not that easy and, when done, often not successfully.

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Little Known About Success Stories

Private equity firms and midsized and larger CPA firms traditionally have not mixed well because:

- CPA firms manage and lead for the longer term and think about the "institution" while private equity thinks short term and ROI.
- There is a caring culture in CPA firms and the senior partners truly see their employees as their most important assets. This conflict, and the employment displacement it presents to midsized to larger CPA firm partners and staff, causes many CPA firms to frown on private equity transactions.
- Other reasons, including initials cuts in partner compensation and earn out periods that need to be achieved.

Other negative factors include:

- Private equity firms will keep senior CPA firm partners initially employed to make sure clients are properly serviced and transitioned but, after a short period of time, some of these same partners might be pushed out of the firm
- Private equity firms may load up on debt that usually amounts to at least three-to-four-times EBITDA.
- Partner perks and discretionary expenses will be brought down to minimum amounts.
- Cash management of receivables and payables will be run very tightly.

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Little Known About Success Stories con't

CBIZ and **UHY** are examples of private equity transactions.

- **CBIZ** is now public and doing well.
- **UHY** remains private as a mid-market firm.

Known "busts".

- In 2007, private equity purchased about 80% of Philadelphia-based accounting firm, **SMART and Associates**, for $60M by refinancing $60M of debt and liabilities. **Smart** was combined into publicly-traded consulting firm **LECG** and went out of business in 2011. In the 2008 recession, lenders started making demands, "and they could not get out from under it" according to senior partner Jim Smart. Many **SMART and Associates** partners and staff hit the pavement and started looking for new positions.
- **Goldstein, Golub & Kessler** was acquired by **American Express** and was subsequently spun out
- **McGladrey** was acquired by **H&R Block** and was subsequently spun out

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What's the "Plumbing" and Corporate Governance Look Like?

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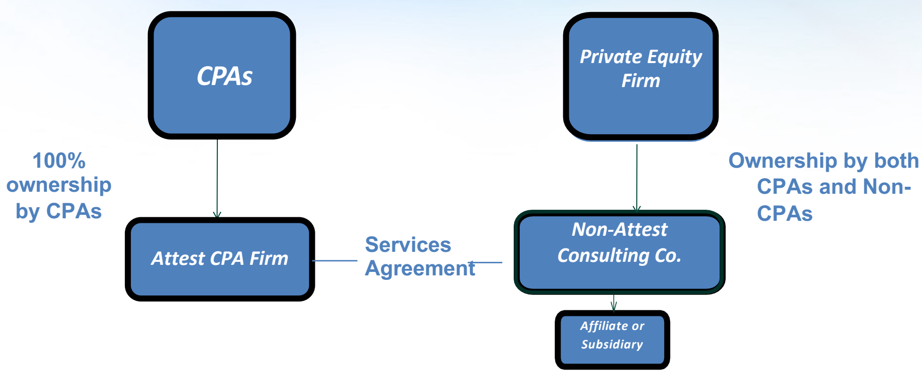
Will There be An Alternative Practice Structure (APS)?



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"APS" Corporate Governance Structure

- Must satisfy **AICPA** 101-14 requirements and state laws:
  - Each director is a licensed CPA and ***Attest CPA Firm*** partner.
  - Substantially all owners of ***Attest CPA Firm*** will also be employees of ***Non-Attest Consulting Co.***
  - The Board of ***Attest CPA Firm to*** include ***Attest CPA Firm*** employees.

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"APS" Corporate Governance Structure con't

- ***Attest CPA Firm*** Board is distinct from ***Non-Attest Consulting Co.*** Board.
- ***Non-Attest Consulting Co.*** employees on ***Attest CPA Firm*** Board are not directors, executive officers or senior management of ***Non-Attest Consulting Co.***
- ***Attest CPA Firm*** is independently managed:
  - Managing Partner of ***Attest CPA Firm*** reports to ***Attest CPA Firm*** Board.
  - Promotion to or removal of an ***Attest CPA Firm*** partner is decision of ***Attest CPA Firm.***
  - Services Agreement provides that ***Non-Attest Consulting Co.*** does not control the governance, structure or operations of ***Attest CPA Firm.***

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Services Agreement

Non-Attest Consulting Co. provides administrative services.

Non-Attest Consulting Co. provides personnel, including "licensed CPAs" to *Attest CPA Firm* to enable it to perform services for its clients.

Statement that services rendered on behalf of *Attest CPA Firm* by CPAs will be under direction, control and supervision of *Attest CPA Firm* and will be rendered in accordance with the Personnel Manual and other policies and procedures.

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Is Private Equity Infusion an Effective Vehicle to Create CPA Firm Partner Wealth?

- If a CPA Firm has a strategic plan that it revises to reflect how strategies and tactics will be enhanced as a result of the private equity infusion, and the "APS" effectively delivers on the enhanced strategic plan, the answer is a definite ***yes***.
- ***The question is – is the gain worth the pain?*** With bank borrowing rates being so low and partner cash capital accounts not at the levels they could be, is a vehicle other than private equity a better ***"wealth creation"*** path? **Time will tell.**

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Where Do You Go From Here?

How do you compete if PE is not in your future?

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Thank You

Q & A

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18