

# Brace Yourself for More Mergers

## Key drivers are at work in practising firms

By Andrew Jenner and Phil Shohett

Recent months have seen an increase in merger activity as firms seek to maintain client service while achieving economies of scale.

The last few months has seen an increasing amount of merger activity and changes in the UK Top 50, including the announcement before Christmas of Tenon and RSM Bentley Jennison getting together to form the 7th largest UK practice, overtaking Baker Tilly. The Top 50, where the entry point is £10m, is contracting. In Ireland the Top 20 entry point is €4m and firms above and below that line have been acquisitive. All the talk has been about size for maintaining and enhancing client service and economies of operation, but there is always a winner and a loser in a merger, one dominant firm and culture no matter the size of the merging parties.

On both sides of the Irish Sea the top of the mergers and acquisitions (M&A) pyramid mirrors the pool beneath and the volume of activity is increasing. The face of the accountancy profession is changing: if the number of multi-partner accountancy firms is decreasing, those remaining are getting larger by acquisition, with the ability to offer an extended range of quality services to clients. Looking ahead, sole practitioners will continue to decrease in number, whilst other firms will cease to carry out functions traditionally offered including audit, more difficult tax situations, corporate finance etc. We have had 10 years of increasing regulation and cost, and now the deepest recession of recent decades. Clients' requirements are ever more demanding, especially those at the top of the pareto. Most firms' profiles show that there is a disproportionate amount of annual fee income generated by a small



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proportion of the client base. These need protecting. Smaller client loss can be relatively easily replaced, but to replace any of the larger clients will be very demanding and highly competitive.

These factors are driving tougher pricing of fees, and producing a harsher and bleaker accountancy landscape. This influences firms and issues within them are surfacing which may have been masked or ignored in better times, such as:

- ▶ **Dealing with underperforming partners.**
- ▶ **Dealing with succession issues which might have threatened the continued existence of the firm**
- ▶ **Installing more effective leadership and management.**
- ▶ **Blending different personalities to build a firm which is better able to meet the difficult challenges that lie ahead.**

Such things often set partners thinking along the lines of 'a merger or sale will provide opportunities to

implement changes that it is difficult or impossible to effect on our own'. Fundamentally this is the wrong rationale, a merger will not be a panacea for all ills. The alternative, where such circumstances exist, is to deal with them before going to the market, thus presenting a stronger impression in negotiations and not speaking from weakness.

Retirement and succession is being driven by the recession, as too many firms have got by on weak financial management and performance, and/or do not have the strength of management in place for the current climate. Some firms have overstretched themselves financially over the years (drawings too high, investment too low). For many others the severity of the recession has eaten into their client base and the trading difficulties experienced by clients are themselves heavily impacting the practice. As a result, partners are having to make difficult decisions about their own businesses (redundancies, pay freeze, cut backs on marketing and training, partners working more at the coal face),

and some view merger or sale as a strategic solution.

Alongside are firms who look at things from a different perspective, enjoying relative strength achieved through past reorganisation and business focus, and actively seeking non-organic growth to take advantage of the choice in the market.

Merger is not a strategy, it is a means to an end, which is to build greater competitive advantage and a more profitable practice on a sustainable basis. If this objective can always be seen as the primary purpose then the possibility of achieving a good merger is enhanced as the aspirations/needs of the partners involved may be met.

There is a tendency amongst accountants to concentrate on the financial aspects of putting two practices together, but the essential feature must be to spend time on the business and the partners' culture. People buy people first, and without communality of approach there is far less chance of a successful amalgamation. By looking at the culture it is possible to take into account the organizational structure, management approach and indeed profit sharing arrangements, as well as the compatibility of how clients will be run. For example, if the partners in one firm prefer to work at the coal face on detailed work, but in the other firm they are departmentalized and devolved, something has to give!

Every practitioner has to strike a balance between what is and is not acceptable for his personal circumstances or for his firm's situation, and there are two fundamental issues to consider:

- ▶ **Why merge?**
- ▶ **Why merge with the specific target firm?**

Analysis of accountancy firm mergers shows that many are driven by ambition, opportunism or need, or a combination of all three. In the present climate the real focus for most is primarily on need, and the reasons will include one or more of the following:

- ▶ **Defensive reasons to merge.**
- ▶ **Need for access to resource.**
- ▶ **Need for access to larger / different markets.**

- ▶ **Increased ability to win work.**
- ▶ **A catalyst for change is required.**

A defensive reason is a common ingredient. For example, in the case of a firm where there is a client which accounts for say 10% of turnover (and growing), then that may be becoming too large a client for safety. Many sole practitioners and smaller firms experience such a client situation. Merger with another firm of similar or larger size could reduce risk exposure to a more manageable level, with a larger firm's greater resources better able to provide the more specialist services that larger and developing clients require (and can counter any issues with service levels that the smaller firm might experience).

For the smaller merged firm (and the majority of firms are no more than 5 partners) there are other variables. To compete on a level playing field they will need to provide broader services than niche firms, but be more focused than fuller service firms, and recognise that size in certain markets (in the form of people) may be required if they are to compete. In such a case, a merger should help to build a certain critical mass, not for size's sake, but to provide the necessary resource to enable the merged firm to better provide clients with what they want, when they want it and where they want it, and to do so more competitively than either of the two legacy firms on their own.

One can query whether growth is capable of being achieved organically by firms in order to provide the necessary resource and economies of scale, but organic growth requires a great deal of investment, in terms of effort and finance. Firms reach a point where a quantum leap is required, but to achieve the critical mass the partners would still need to make significant decisions:

- ▶ **What kind of firm do they wish to be?**
- ▶ **Which services should be the focus or be dropped?**
- ▶ **Is one office location, or more, required?**
- ▶ **How should the business be managed?**

None of these issues are easy to resolve and organic growth, on its own, is unlikely to be the only answer to a firm's needs.

Recent events prove that merger can provide access to greater resource such as breadth and depth of expertise, and finance; and the combination of two firms can address any perception that there is no depth below partner level. Smaller practices are unlikely to have the volume of work to justify recruiting a specialist, but a merged firm may well have the work to justify the cost, the investment likely to be less than it would have been in either legacy firm.

In other situations the economies of scale which can be created by a merger will come through with a larger firm having the added capacity to recruit an administrator, replacing the time and effort of partners in the mergee firms who in the past would devote a greater proportion of their time providing financial management, HR, infrastructure and compliance, etc.

Combining two firms can give access to larger markets to capitalise on service or sector expertise, giving the practice the potential to enter markets which currently may not easily be accessible, and where potential clients in those markets are not even aware of the firm's existence. Joining with a firm which has been established for a long time and is well known and respected in the target market can be a platform upon which to build.

For example, many practices would like to develop niche sector(s) but are too small to be capable of delivering a broader and fuller service which clients are increasingly likely to require. Putting the two together and concentrating on a limited number of services or sectors at which the firm is good, and for which it is known, even if using its still relatively limited resources, is likely to be a more sensible and successful way forward in the longer term than the two firms trying to go it alone.

We have focused on the key drivers at work, and the areas to be addressed at some stage (sooner rather than later?). There is still choice open to partners to influence their future, but they cannot put their heads in the sand forever, because to do nothing will not be an option available to them.