William Blair

Multiples Expand and M&A Interest Surges in Professional Services

As the amount of capital available to shareholders of professional services firms increases, we examine the unique questions that firms must address to prepare for a successful liquidity event.

Industry Commentary

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Interest in professional services firms from investors, strategic acquirers, and financial sponsors has steadily increased over the past decade, leading to significant multiple expansion across the industry. As the amount of capital available to fund growth strategies and liquidity events for owners of firms that provide consulting, technology implementation, outsourcing, and other professional services grows, we examine the value drivers and unique considerations that leaders of these firms must take into account when preparing for a successful transaction.

Acquirers Aggressively Pursue Premium Assets

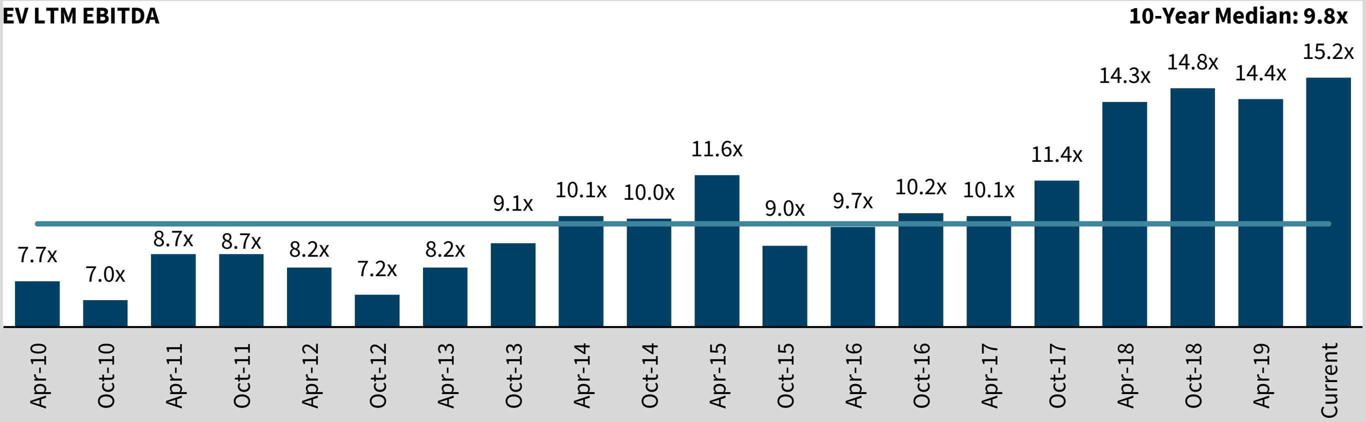
Several long-term secular and strategic shifts have led to the increased interest in professional services firms from strategic acquirers and financial sponsors. Historically, acquirers were hesitant to make major investments in companies whose primary source of creating value—the skill, reputations, and relationships of their people—walked out the door every night.

But in the past decade, these concerns have decreased significantly as a rapidly growing list of successful transactions have validated the roadmap for creating value through M&A in professional services. Furthermore, demand for professional services has grown as businesses of all sizes have embraced the cost and efficiency benefits of outsourcing noncore functions in areas such as legal, operations, business strategy, marketing, procurement, and beyond. Management teams have also realized the need to bring in specialists to help the company navigate major transformations related to strategy, pricing, customer engagement, technology, branding, operational efficiency, or other trajectory-defining elements.

Against this backdrop, strategic acquirers are pursuing M&A for a multitude of reasons. Firms that are focused on technology solutions are acquiring strategy capabilities and vertical industry expertise as a way to create stronger relationships with clients and move up the value chain. Conversely, strategy-focused firms and vertically oriented consulting firms are looking to add digital transformation capabilities to address a critical need at their clients and capture a larger piece of the client's spending. Other firms are using M&A as a way to expand into adjacent services, new verticals, or new geographic markets, while others are simply looking to build scale and "buy growth." Furthermore, firms continue to expand service offerings, blending public-sector and commercial

Multiples Expand for Publicly Traded Professional Services Firms

The growing attractiveness of the professional services industry is reflected by the expansion of multiples for publicly traded firms, particularly since the beginning of 2018.



Source: S&P Capital IQ and William Blair equity research as of October 22, 2019; includes the following firms: Accenture, Charles River Associates, Exponent, FTI Consulting, Huron, and ICF

consulting as well as expanding into more managed-services-type offerings, often in an effort to generate more recurring revenue. Scale has become an increasingly important driver of profitability and M&A activity in professional services. The nature of professional services has evolved in a way that now creates some competitive advantages for larger firms. The Big Four accounting firms and large strategy consulting business have significant resources to invest in intellectual property, technology (both internal solutions and client-facing tools), new capabilities, and geographic expansion. This is leading some consulting firms to redefine what it means to have sufficient scale in this industry.

Acquirers' aggressive pursuit of professional services firms has led to robust M&A multiples. Over the past three years, highly attractive professional services firms typically have traded in the 10x to 14x EBITDA range. At William Blair, we have been at the forefront of the surge in professional services dealmaking activity. Our recent work as sell-side advisor to professional services firms includes:

- ECG Management Consultants sale of a majority stake to Siemens Healthineers
- JS Held acquired by Kelso & Company
- Bolder Healthcare Solutions acquired for $485 million by Cognizant
- Silverline acquired by Pamlico
- ICR's equity investment from Investcorp
- Kurt Salmon acquired by Accenture
- AlixPartners acquired for $2.5 billion by an ownership group including founder Jay Alix, Caisse de dépôt et placement du Québec, Public Sector Pension Investment Board, and Investcorp

Other recent headline transactions in professional services include Capgemini's $5.6 billion acquisition of Altran, Tieto's $2.2 billion acquisition of Evry, Guidehouse's $1.1 billion acquisition of Navigant, and CVC Capital Partners $700 million acquisition of Teneo.

Value Drivers in Professional Services M&A

There are several key factors that can drive valuations higher or lower within the typical EBITDA multiple range for professional services firms. Buyers or investors closely evaluate the following characteristics in determining how aggressively they want to pursue the target:

Value of platform vs. individuals: Buyers or investors want to know that they are acquiring a true revenue-generating platform rather than a collection of talented individuals. Firms that have built leverage and scalability into their models are significantly more attractive than firms that rely predominantly on the expertise and relationships of the individual partners to drive revenue.

Uniqueness of skill sets, partnerships, and intellectual property: Buyers evaluate the ease with which they or a competitor can provide similar services through organic hiring. Hard-to-find skill sets, unique intellectual property, strong client relationships in a specific vertical, and established partnerships with technology vendors (particularly those with limited partnership networks) can drive higher valuations.

Growth opportunities: Beyond simply looking at historical and projected growth rates, buyers or investors will evaluate the mix of organic and inorganic growth drivers. For the latter, they will focus on management's track record of successful M&A execution and integration as well as the roadmap for future acquisitions.

Leverage of technology, managed services, and products: Buyers or investors will evaluate how well consulting firms have leveraged technology to enhance their internal operations, as well as invest in new ways to deliver value to clients. Consulting firms that have been able to leverage their client relationships and intellectual property to sell technology solutions and managed services can often achieve a premium valuation.

Repeat and recurring revenue: Buyers or investors typically will ascribe a higher value to revenue that is generated by subscription-based services than by project-based work. Even if a firm does not have long-term contracts with clients, the ability to show a high percentage of repeat business and long-standing relationships boosts the multiple.

Revenue mix and concentration: From a risk-management perspective, buyers or investors get concerned if a large percentage of revenue is generated by a few clients or by a small group of professionals within the firm. Furthermore, buyers or investors want to see that a firm is actively developing the next generation of revenue producers at the company.

Utilization and profitability: In addition to high utilization rates among the firm's professionals, buyers or investors will want to see that the firm's staffing model is properly aligned with the revenue model. They will closely evaluate how fluctuations in utilization are reflected in profitability. Buyers or investors also want to see that a firm is investing adequately in technology, infrastructure, and essential back-office capabilities to support sustained growth. If margins are currently high simply because investments in these non-revenue-producing capabilities have been pared back or neglected, this will raise doubts about the firm's ability to continue growing without sacrificing margins.

Preparing for a Successful Transaction

Any successful M&A transaction or liquidity event requires diligent preparation, but this is especially true for professional services firms given the nature of their people-based business models and the requirements of buyers' and investors' diligence.

Shareholders' objectives will drive the appropriate transaction structure and strategy, so it is essential that partners, the board, and other shareholders create alignment on what they ultimately are looking to achieve. Are the shareholders looking to maximize liquidity on the front end or is the priority a larger "second bite at the apple?" Which of the partners want to stay on at the firm following the transactions—in a full-time role, as a consultant, or a board member? Are the shareholders comfortable taking on debt? What will happen to the employees and the company's brand following the transaction? These are just a few of the critical questions that must be addressed before starting the transaction process.

Compared with other industries, professional services transactions raise a host of unique concerns that the buyers or investors will explore during the diligence process. It is essential to address these well before the transaction process commences. Some of the most critical elements to address include:

Cultural alignment: With a business where the people are the essence of the firm, ensuring that there is alignment with the firm's culture and vision is essential. This cultural alignment can be difficult to articulate to buyers or investors, but it is best validated through multiple rounds of conversations as well as by giving buyers or investors exposure to the right mix of employees throughout the firm during the diligence process. Deciding which employees to include in these conversations, however, must be handled carefully because of

Considerations That Drive Transaction Structure and Strategy

It is important for shareholders of professional services firms to achieve alignment and clarity on the following topics before launching a transaction process.

Consideration	Commentary
Value	Total proceeds received for the business and timing of receipt (e.g., stock, cash, earn-outs)
Transaction Structure	Will the transaction be structured as an asset or stock sale? Will the business be sold as one entity?
Liquidity	Cash proceeds to owner(s); greater liquidity reduces overall risk to equity holders, but minimizes future upside potential
Management Dynamics & Ongoing Involvement	Whether or not ownership is to stay on as management, board member, consultant or in another role: can work both ways and vary by individual
Legacy / New Ownership	What will happen to the company/brand name post-transaction? How will the business be n1n?
Type of Buyer	How much access does the buyer have to capital? What strategic access/sector expertise can the buyer bring to the business?
Employees	What happens to employee base and/or certain certain facilities post-transaction? Will there be layoffs, consolidations, etc.?
Confidentiality	Minimize the risk of process leaks and protect sensitive information
Timeline	How quickly can a process be completed? Is timing a critical factor?
Overall Business Disruption	How intensive/disruptive will the marketing and diligence process be?
Debt Sensitivity	How much leverage will a buyer put on the business? Will too much debt constrain the growth of the business?
Competitive Concerns	Will competitors be approached and how? How broad will the potential buyer outreach be?

confidentiality concerns and the risk that some employees might become worried about the potential for a sale and begin searching for a new job.

Alignment of equity ownership and go-forward productivity: Potential buyers or investors will want to see that the most-productive employees are given incentive to stay with the company post-transaction. If there is a current mismatch between the productivity of employees and their equity ownership, firms will want to address this proactively through compensation, retention bonuses, stock options, or equity rollovers. This is not something that should be addressed during the transaction process because a highly productive, undercompensated, or under-equitized employee could threaten to leave and undermine the transaction.

Partner compensation: Many professional services firms aggregate equity distributions into the partners' earned income, effectively creating a compensation structure that pays partners well above the market rate. M&A and capital-raising transactions are based on EBITDA multiples, so the firm needs to arrive at a "normalized" EBITDA that adjusts for equity distributions. Determining an appropriate market-based, go-forward compensation plan that provides minimal disruption will be essential in allowing the buyers or investors to properly value the company.

Transaction structure: Private equity investors will typically require shareholders of professional services firms who are also critical executives or rising leaders to roll over a significant portion of their equity. So if a firm is going to pursue an investment from a financial sponsor, there needs to be an up-front discussion among the shareholders about their goals and timelines. Specifically, shareholders need to evaluate their priorities in terms of current liquidity and enhancing the potential value of a "second bite."

Deferred compensation and employee retention: To ensure the retention of partners, some buyers or investors will insist on either equity or deferred compensation structures based on contingencies. These deferred compensation plans often have options or profit units that vest based on an individual's length of service or firm performance measures, so determining clear definitions of those triggers and assessing the likelihood of achieving any profitability goals is critical. Furthermore, it is likely that buyers or investors will require key producers to sign non-compete and non-solicitation agreements as another way to enhance employee retention.

At William Blair, we have extensive experience guiding owners of professional services firms through the complexities of these transactions. Having worked on many recent high-profile transactions in the industry, we are uniquely equipped to advise firms on how to maximize their value and capitalize on the robust demand from strategic buyers and financial sponsors. To learn more about the trends shaping dealmaking and capital raising activity in professional services, please do not hesitate to contact us.

How Defining EBITDA Affects Valuation

Defining a go-to-market EBITDA is critical in any transaction process. For many professional services firms, this means "normalizing" EBITDA by distinguishing between equity distributions and compensation. The table below illustrates the incremental value that could be created by shareholders forgoing enough profit distribution to enhance the firm's EBITDA margin from 10% to 20%.

($ in millions)

Illustrative Purchase Multiple	**10.0x**	**12.0x**	**14.0x**
10.0% EBITDA Margin	$10	$10	$10
Implied Valuation	$100	$120	$140
15.0% EBITDA Margin	$15	$15	$15
Implied Valuation	$150	$180	$210
20.0% EBITDA Margin	$20	$20	$20
Implied Valuation	$200	$240	$280

Pre-Tax Analysis			
Forgone Distribution Profits from 10% Margin Difference	$10	$10	$10
Incremental Value Gained from 10.0% to 20.0% Margin	$100	$120	$140