ROPES & GRAY

Unpacking Private Capital's Growing Interest in Professional Services

Authored by:
Craig Jourdan,
Nick Matthew,
Elizabeth Todd and
Paul Armstrong

In recent years there has been increasing private capital investment in professional services firms—we are seeing continued evidence of this demand in 2024 and a strong pipeline for 2025.

Accounting, audit, tax, expert witness, consulting, risk, law firms and others ... why is private equity interested in the professional services industry?

- **Professional Services firms operate in a large fragmented market**—with sufficient levels of capital behind them they can **buy and build** to achieve scale. Just last week we saw a group led by New Mountain Capital invest in the US-based unit (non-audit) of Grant Thornton, and at the beginning of this year we saw Hellman & Friedman and Valeas Capital Partners invest in Baker Tilly, making it the largest private equity investment in the US CPA sector to date (at the time). In the UK, Hg Capital supported the formation of Azets through the merger of Visma BPO, Blick Rothenberg, and Baldwins in 2016. Azets has since completed the acquisitions of Wilkins Kennedy, Tait Walker, Campbell Dallas and Gorilla Accounting, and is now a UK top 10 accountancy firm. More recently, Horizon Capital invested in Dains in 2021. Dains has since acquired PSTAX, 3STAX, HSKS Greenhalgh, and, most recently in 2024, McInerney Saunders Chartered Accountants and Midlands-based Magma Chartered Accounts.

- **Many professional services firms are exploring new technologies** such as AI and generative AI—firms in the sector are racing to best utilise AI to increase service offerings and efficiencies. Whilst a pivot to AI has a great deal of focus—private equity sees opportunity in outsourcing and offshoring to reflect the needs of today's enterprises to be flexible and able to manage margins. Private equity sponsors, using their capital and expertise, can allow firms to make necessary investment in these areas, where partners of professional services firms may be unwilling to put personal capital at risk for long-term investments.

- **They typically have a 'sticky' customer base and are cash generative.** Due to the nature of the services professional services firms provide (particularly accountancy and tax), revenues are typically predictable and recurring as their clients require repeat servicing year on year. This is especially the case where their services are provided to government agencies or financial institutions, or where their offering relates to complex matters where customers cannot 'in-house' the services. For the same reason, their revenues are resilient to turbulent market conditions, which is now more than ever a key consideration for private equity firms due to macro-economic and geopolitical uncertainty. Furthermore, their underlying client bases are diverse and frequently spread across sectors and geographies, reducing/mitigating macro economic and sectorial viability.

- **Valuations of professional services firms** often take into account the capital which a private equity firm will need to inject to improve the business offering. This can mean better opportunities for multiple expansion on a future exit.

- **Shifts in the regulatory landscape** are creating new opportunities for private equity investment in the sector. For example, increased scrutiny by regulators of the UK audit sector with the aim of improving oversight of corporate finances has resulted in the UK's 'big four' accountancy firms exploring and, in some cases, implementing the sale of certain non-audit operations. Separating audit and advisory businesses is a way of removing conflicts of interest and operational challenges under the auditor independence rules.

The complexities of investing in professional services firms

- A target professional services business is often one part of a larger business and needs to be separated or 'carved-out' from the wider business. **Carve-out transactions** involve a range of complexities, including mapping out the correct people and services which are to transfer across, the need for transitional service arrangements, and having certain capabilities and functions (often including regulatory licenses) stood-up on Day 1 following completion.

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- A key value of any professional services firms is its **people**. There is a risk that **key personnel** could choose to leave the business and take clients and intangible assets with them. Putting in place the right **incentivisation plan** is crucial to any investment in a professional services business as a tool to retain the best talent. Private equity investment can offer an alternative to a partner profits compensation structure—former partners can be paid out, and more junior talent can be rewarded with bonus and equity schemes in a new more flexible compensation structure. Given the focus on talent incentivisation and the scale on which plans need to operate to capture the business' key personnel, incentive plans can become administratively burdensome and costly to operate unless appropriate processes are put in place.

- Whilst **defined benefit pension** schemes are increasingly closed to new members, the buy and build strategy often seen in this industry, together with large employee numbers, presents a risk of historic defined benefit pension liability. Defined benefit schemes are potentially the largest and most unpredictable liabilities on a target's balance sheet and can create issues when buying and exiting a professional services business. However, the current interest rate environment may facilitate buying out or insuring these DB schemes—which may have been historically economically prohibitive.

- **Regulatory and compliance issues** surrounding any professional services firm require particular attention, especially those firms with an audit practice or law firms. Audit firms in the US cannot be majority-owned by non-certified public accountants. This, for example, led to TowerBrook Capital Partners' acquisition of EisnerAmper in 2021 needing to be structured such that EisenAmper was split into two entities: one owned by CPA partners called EisnerAmper LLP, and a tax and consulting business called Eisner Advisory Group LLC which could be majority-owned by TowerBrook Capital Partners.

- Professional services firms will typically require **professional indemnity insurance.** Costs of professional indemnity insurance have soared in recent times. These increased costs will need to be factored into any private equity buyer's valuation. Large cap private equity is also now examining the use of captives to have better line of sight and control on these costs.

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- Given this is a relatively new sector for private equity investment, there may be concerns about PE firms' **ability to exit their investments.** However, we are seeing a growing appetite for PE investment in the sector, and it is likely that selling to other PE firms or bringing in co-investors will provide PE firms potential realisation routes. For example, Permira sold down their majority stake in Kroll (formerly Duff & Phelps) to a global investor consortium led by funds managed by Stone Point Capital and Further Global in 2020. Other competitors in the market who are themselves looking to grow to achieve scale or diversify their business means that an exit to trade may also be possible.

Those who are able to work through the complexities of doing these deals will continue to invest and find value in the professional services industry.

Ropes & Gray has considerable experience advising on investments in professional services firms in a variety of sectors and on other forms of complex carve-outs, management incentivisation plans and business restructurings. We can advise at all stages of the process, from initial discussions through to transaction implementation.

Relevant Experience

SOURCE ADVISORS

Represented **BV Investment Partners** in its acquisition of **Source Advisors**, a US tax consulting firm, and subsequently represented **Source Advisors** on its acquisition of **GovGrant**, a premier UK-based R&D tax relief services and Intellectual Property consulting firm.

ERM

Advised **ERM**, the world's largest pure-play sustainability consultancy, and the ERM Partner shareholders, on the sale of ERM to KKR.

Wallbrook.

Represented the **majority sellers of Wallbrook**, a leading global ESG advisory firm, on a merger with **Anthesis** (the sustainable performance activator and largest group of dedicated sustainability professionals globally).

Bridgepoint

Represented **Bridgepoint** on its acquisition of **Achilles**, a supply chain risk and performance management business.

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