Merger Ahead

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In recent years, conventional wisdom has stressed the importance of organic growth for law firms. As the credit crunch bites, mergers provide the best strategy for growth, Nigel McEwen argues:

In the past 20 years, the legal profession has experienced very healthy growth. In 1988, there were 40,000 solicitors. In 2008, there were 110,000. The legal sector now outstrips agriculture as a contributor to national economy – contributing two per cent to UK gross domestic product. Profits per partner have risen significantly across the country over the past five years. Of course, life in firms dependant on legal aid has been challenging, but in general, these two decades have been, for solicitors, a time to make hay while the sun shone.

The importance of growth

In this climate, one factor common to many law firms has been pride in their growth: “Our turnover has gone up 36.3 per cent during the past six months”; “this is our 15th new partner in the past year”, and so on. Those firms not growing were seen as going backwards. Gaining extra turnover and staff typically leads to higher leveraging of partners to fee earners – a key constituent of higher profitability. It also makes firms more attractive for new recruits, allows easier succession planning, and facilitates the ability to offer specialised services, and the opportunity to gain greater returns from investment in IT and marketing. Some firms have enjoyed great success by remaining smaller with a niche market base, but by and large, those firms that have grown have enjoyed the most success – in terms of profits, strong financial bases and fulfilling work for their staff.

Many law firm leaders believe that size does matter, especially in an increasingly competitive market. These firms know that bigger firms will, on average, provide a number of different specialised services, acting as a counter-balance to over-reliance on one area of work. Firms with good litigation and insolvency departments will probably be better able to ride out the gathering storm, while smaller firms concentrating on property work are now feeling real pain as they are forced to cut their staff and overheads. Those practices with high levels of publically funded work have also benefited from growth; research carried out for the Carter report (Legal Aid: A market-based approach to reform, 2006) shows that bigger firms undertaking legal aid are the most profitable. The common wisdom now is that law firms now need at least 15 fee earners to be viable.

Partners in law firms are also recognising the need to have expertise in their marketing departments; only the bigger firms can provide the in-depth resource that is needed for both the consumer and commercial client bases. Investment in customer relationship management systems, branding exercises and advertising/sponsorship activities makes much more sense if spread across a bigger turnover.

Finally, in recent years, the key issue of excellent management and leadership of law firms has been recognised as a distinguishing factor between the more and less successful practices. Bigger firms can afford to have full-time managing partners, with the time and resource to plot the firm's strategic response to the ever faster pace of change in the profession. The market is now so competitive that giving senior lawyers more opportunity to study their market, motivate colleagues, build client relationships and nurture the next generation of partners is not an option: it is a prerequisite of survival.

Turning point

This year marked a turning point on the seemingly unstoppable pursuit of growth. Property revenue has been hard hit, as have many other types of transactional work, as clients sit on their hands, have their own cash crises, or are unable to borrow. What's more, the impact of the Legal Services Act 2007 (LSA 2007) is lurking around the corner and will have a bigger impact than many think.

New breeds of law firm are already stalking the market. Take, for example, Minster Law. Minster already employs 450 staff and aims to be among the 25 biggest law firms in England and Wales by 2010. The firm has built its volume practice around professional indemnity work but is now extending into property, family and employment. Supported by a major investment in IT and having rejected partnership models, it is among an emerging group of new style businesses competing head to head with traditional legal practices that will be up and running before the LSA 2007 is fully implemented in 2012. Most of these firms will target the consumer market, but new entrants with support from wealthy backers will also eye the commercial market. Sophisticated marketing techniques and tough and experienced managers who will operate without the drawbacks of the collegiate partnership culture will drive the business objectives of significant returns and high market share – objectives which have been largely ignored in the legal sector.

Some might feel that the new legislation will not have much impact on the legal sector; however, you only have to look at the changes that have taken place in the opticians' marketplace during the past 20 years to realise this is unlikely. Following the deregulation of this sector in the mid 1980s, there has been massive consolidation and the triumphal entry of new suppliers; 70 per cent of this market is now supplied by four providers. Last year, Specsavers spent £27 million on advertising. Which law firm could currently compete with that level of marketing spend, or would even know how to spend that sum of money? Obviously, the opticians market is totally retail-based and is geared towards mass volume; the legal sector operates very differently and will never have the same level of penetration by big scale operators. Nevertheless, and despite the current downturn, the legal arena must look rather tempting to those wanting to exploit new, fragmented markets with big opportunities to cross-sell insurance, financial and other products.

There are still a number of smaller firms with niche practices and clear focus which will thrive, but the momentum is clearly towards pursuing greater chances of higher profitability and financial stability in the bigger firms. For most, however, there are now fewer opportunities for organic growth; it will be the exception rather than the rule. The days of double digit increases in revenue are unlikely to return for quite some time.

Reasons for merger

Many firms are now pursuing another strategy: merger. Many senior solicitors still acknowledge that they want their firms to be bigger, and the pursuit of growth remains part of their vision; they do not want to be thwarted by current dire economic forecasts. For others, the impetus will be led by defensive reasons, such as a reliance on “strength in numbers” (although this is not necessarily a guarantee against the buffeting of the credit crunch). Other firms will still want to gain geographical supremacy in a particular region, add complimentary work flows or simply spread overheads over a wider revenue base.

The momentum towards fewer law firms is now unstoppable. One factor alone has led to the legal profession historically being among the most fragmented of sectors: the requirement for a local physical presence as an essential part of service delivery. But the need for a locally accessible office is no longer seen as essential, with the widespread use of the internet and mobile communications. Clearing banks now positively discourage customers from going to their premises. Lawyers will increasingly follow this trend, with firms having regional dominance from one or two big offices.

The recent Smith & Williamson annual survey of leading firms showed that during a time when confidence among those firms was “plummeting”, six out of 10 respondents stated that they thought the number of mergers would rise. This finding is supported by much anecdotal evidence. Without a significant marketing budget, mergers are the most effective engine of expansion in today’s economy.

Timing

The questions of when and how to merge are perhaps more challenging than why. The “how” is a topic big enough to fill a textbook, so let me concentrate on the issues of timing. Most partners in law firms will naturally want to negotiate a merger from a position of strength – that is, at a time when they have record profits and a strong pipeline of work. Sadly, not many firms are in that position at present. Expectations need to be carefully managed, and this is the first crucial task of those leading a merger strategy. At SSG Legal, we have talked to dozens of managing and senior partners during the past six months about their merger plans, and our experience is that, unless the ground is carefully prepared, negotiations will inevitably flounder, or even not start at all, and partners might be so shocked by a sudden push towards a merger that the sponsoring managing or senior partner suffers a serious loss of credibility.

A merger of law firms is usually a life-changing event for partners and staff, so a structured approach is not only good commercial practice but will also appeal to the logical and rational way in which most senior lawyers approach problems. Do the right analysis before entering the fray. Set aside time for internal debate. Fee earning work is naturally very important, but all too frequently partners do not spend enough time discussing their future in a planned and controlled way. Ask the right questions about where you are now and where you want to be. Get buy-in from partners. Be honest about what you want and about what you can reasonably achieve. This is a vital period for many practices and devoting resources to the “whys” and “whens” of mergers will reap dividends at this time of profound change and fast-paced consolidation in the legal sector.

If, as is likely, your firm is at least giving thought to merging, ask yourself and your partners the following questions:

- Will being bigger help you achieve the firm’s goals? Are those goals, in any event, really clear and agreed?
- Will being part of a bigger firm increase the partners’ job satisfaction or help them to meet their aspirations? How can a merger actually protect the things that we like about our firm (and help us change the things we don’t)?
- Are partners defensive or offensive? What is the mood for taking some calculated risks?
- How will your clients perceive a merger? Will they think that they are going to be charged higher rates by a larger firm without any extra benefits? How do you know what they think?
- Does your firm need to become leaner, generate more income per fee earner, or cut some premises

costs before you enter discussions? How are you going to do this? How do your profits per partner compare with the firms that you would like to merge with? How much extra profit could you generate if you could reduce some key overheads?

- How healthy is your cash flow? Once figures have been exchanged with your potential merger partner, the costs of a merger can be identified – marketing, write offs, premises alterations and so on. These costs might be impossible to fund. On the other hand, a merger is a "once in a lifetime" opportunity to bill all that work in progress which has been lying around for years. The cash generated might alone pay for the merger bill. Financial issues are the most important as we enter 2009. Many managing partners are focused on reducing their headcount as the quickest way of improving profit and reducing borrowings. A merger might be a distraction from core activities. Nevertheless, interest in mergers will not subside. The economic and regulatory concerns are not going to disappear. The advantages of reducing unit costs will be ever more attractive as the recession bites harder, and leaner and more aggressive new entrants bludgeon their way into the market. The more forward-thinking firms are lining up their targets. They want to lead the market and others will not want to be left behind.

If you would like to find out more information about Nigel McEwen or the merger services provided by SSG Legal, please go to www.ssglegal.com or don't hesitate to contact him via email at nigel.mcewen@ssglegal.com or by phone on 0845 643 9343.

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