

PETER SCOTT CONSULTING

Briefing Note August 2017

Succession problems are also acquisition opportunities

The current legal market is excessively fragmented to such an extent that around 80% or more of firms are too small to be viable from an economic and a regulatory standpoint and to compete effectively.

Two factors are now having an impact which will lead to an increasing consolidation of the market.

For some - the need for succession

Many small firms are facing the prospect of the retirement of partners, some of whom may have been the driving forces behind their firms in the past, creating the dilemma of how to replace them (and their capital) to secure the future.

The dilemma is even worse for sole practitioners who when facing retirement have even fewer options.

For others - the need for profitable growth

Other law firms are also not immune from the need to take steps to safeguard their long term futures, which will depend on continuing to be able to provide their clients with value for money legal services they need and will demand. These firms need to grow in a focused manner to provide the resources of finance, expertise and infrastructure now needed if they are to become competitive.

1. Firms seeking profitable growth

These firms are likely to identify that not only do they currently have insufficient resources to achieve their ambitions but they also realistically recognise that *on their own* they will not be able to build such resources at an acceptable economic cost to their partners. **Scale** is therefore required if the necessary stronger resource platforms are to be developed. Achieving this will enable a law firm to better:

- Grow its ability to attract, retain and develop the best people.

- Build a management support infrastructure and know how / expertise to underpin the effective and efficient provision of the high quality legal services clients now require.
- Provide enhanced ability to exploit opportunities and to provide clients with the services they now need, where they need them and how those services are delivered.
- Build a higher level of sustainable profitability than is currently being achieved
- Ensure more effective risk and compliance management which have now become not only high priorities for law firm managements, but in reality mandatory requirements.

How can a firm which needs to build a stronger platform for focused growth achieve this?

For a firm looking to expand by non-organic growth, there may be a number of internal obstacles to achieving what might be regarded as a 'merger' -

- Many firms I speak with only wish to combine with a smaller firm (presumably for reasons of control)
- They look at a target firm as it is now rather than visualising what *together* the two firms could become
- They only look at the differences between the firms rather than their *compatibility* and how they might 'mesh' together to create something greater than the individual parts (the laws of magnetism come to mind – '*like poles repel, opposite poles attract*')

An alternative to a 'merger strategy' is an **acquisition strategy** by which a firm will aim to acquire good clients, people and expertise from a number of small firms who may be looking for a 'lifeline'. A good place to start would be to identify firms which have succession issues. Firms will have their existing professional networks (banks, accountants, consultants, head hunters and recruiters etc) and these can be enlisted to help search for appropriate opportunities.

I earlier mentioned *focused* growth. Having an appropriate focus to its business is vital for a law firm as clients and prospective clients no longer want generalist law firms, but instead want to instruct firms which have clear specialisms appropriate to meet the needs of clients. This may involve building a focus around particular types of work or types of clients or sectors. At the outset therefore an acquisitive firm seeking opportunities should be clear as to its future business focus and identify firms it is prepared to look at with a view to filling gaps or building new areas of work to strengthen that business focus.

An acquirer is also likely to identify other criteria by which to judge a prospective target. For example

- What will it do for the firm in terms of acquiring quality people, enhancing reputation and building profitability?
- The firm's clients and the ability to retain and develop them profitably

- The people in the target firm, their wishes as to future careers and status and their remuneration
- The firm's claims record and its compliance with regulation
- What impact acquiring the firm will have on cash flow, both in the short and longer term?

A number of targets may need to be looked at and ideally an internal team should be put together which has the skills to effectively consider these matters. If not then appropriate external help should be enlisted.

2. Firms with succession issues

In some firms partners or sole principals have put their heads in the sand and hope the problems relating to succession will just go away. Sometimes this may be because there is not the knowledge or the skills to deal with the problems. Whatever the reason, such problems do need to be resolved because they do not go away but become more acute as time passes.

How should a sole practitioner or a small firm approach dealing with succession?

Options may possibly include:

- Continue the practice by taking in / handing over to one or more other partners, if there are available candidates willing to continue the practice on an agreed financial basis which accommodates an outgoing partner. However, there does seem to be more aversion to taking on risks these days on the part of many younger people and so increasingly partners who would like to retire are finding that this option may not exist. The risks are often perceived to be greater where the clients are concentrated around the retiring partner and where there has been no effort to organise an orderly hand – over to others.
- Close down the practice, with the costs of run – off cover associated with this route, which may make this option unattractive.
- For some sole practitioners who cannot afford to or choose not to, buy run – off cover, this may mean continuing to work while running down their practices to a level of turnover which will make run – off cover more affordable.
- Finding another firm to sell to or to join as the realisation grows that the only sensible option may be to throw in their lot with others.

In this Briefing Note I am going to focus on the last option above - joining with another firm, by looking at how this should be approached, given the likely needs and attitudes of firms seeking acquisitions outlined above.

Firms or sole practitioners with succession issues should ask themselves some questions -

Do I have a business which another firm is likely to want to acquire?

Acquisitive firms are likely to be seeking to add to the existing skills and expertise they already have or to create new areas of expertise. Sole practitioners or small firms should therefore work at building competitive focuses to their practices which are going to be attractive to other firms. By their nature many sole practitioners and small firms already have quite focused and profitable niche practices. In particular, if a firm's practice is -

- in an area of expertise currently in demand and where there is likely to be sustainable growth in the future,
- which another firm needs but cannot itself provide or grow easily, quickly or at an acceptable economic cost
- which is delivering increasing profitability on a sustainable basis from a stable and growing client base

then that firm is likely to be **an attractive target and will have something to sell.**

This is about ***picking winners*** and is likely to require forward planning perhaps ten years in advance to ensure that a firm creates something which will have a value and can be sold. This is not a pipedream – there are many examples of small niche or boutique law firms which have realised their value by carefully preparing their businesses for sale in this way.

On the other hand, small firms with a mixed bag of unfocused and not very profitable work are likely to struggle to find anyone to take them on.

If a firm is in this latter category then it should take a hard look at itself to see how it can make itself more attractive to a potential buyer –

- perhaps there is an area of work which serves no useful purpose and loses money or burns cash which the firm should close down or dispose of, which would then sharpen the firm's focus and make it more profitable and financially stable
- if the profit trend is downwards and debt is increasing then more drastic measures are likely to be needed, not just to prepare the business for disposal but to enable it to survive and avoid insolvency or a 'fire sale'

Does my firm have a value?

This question can often be approached by looking at what a lawyer may have to sell –

- His or her services / labour? – these will have a price / salary in the employment market place
- There may be some ‘hard’ assets such as work in progress or a property which can be realised
- Or there may be ‘goodwill’, which is the difference between the net hard asset value and what a firm is prepared to pay for the business.

NB – in relation to valuation and to ensure you receive your value, always take good valuation, accounting, tax, P I insurance and legal advice.

Research the market

Whether you are a ‘buyer’ or a ‘seller’ you will stand a better chance of finding what you are looking for if you thoroughly research the market. You can do this yourself or use a suitable third party experienced in this line of work.

I find that even in small geographic legal markets, many firms do not really know much about the other firms in that location and the work they do. They often have ‘perceptions’ but rarely any hard knowledge about a firm and its business.

You may have drawn up a shortlist of target firms which you have researched, possibly using various criteria such as ‘compatible cultures’, reputation, strategic fit, market positioning or size. You may then have arranged a meeting with your No.1 target on the shortlist.

At that first meeting you are likely to have no longer than an hour to make an impact and to sufficiently enthuse and excite the other firm with the idea of getting together with you, that they will want to take the matter further and arrange a follow up meeting for more detailed discussions.

As emphasised above, to do this you will first need to have carried out sufficient research into the other firm and the market place in which you both operate to enable you to present a clear and coherent vision for what you could together build. You are likely to have only one shot at this and so preparation is vital, both in respect of the business case you put forward and your communication skills.

You may well be asked searching questions by the other firm which you will need to be well prepared for. For example:

“We can see what we could do for you, but what could you do for us?”

“[Sale / acquisition / merger] is not currently on our agenda, so why do you think getting together with you is something that would be of interest to us?”

“How will putting our two firms’ together make the resulting firm more profitable than we are currently?”

Doing your in-depth strategic research and analysis of the market and the target before you meet is likely to pay dividends and will enable you to give a message to the other party that you have done your homework and deserve to be given a hearing.

If handled well, this initial part of the process, to develop a shared vision, may lead the two parties to arrive at certain realistic conclusions as to the direction in which the two firms should be heading. This may point clearly to their getting together as an optimum route for both. On the other hand, the initial meeting may show one or both firms that doing so (at least between them) would be a mistake.

As part of this process, it is important to look beyond what each firm now represents and instead, consider what the two firms together could build for themselves and the potential benefits which could accrue to both parties. Developing and communicating these messages are some of the most important things that those running the two firms will need to undertake throughout discussions, as well as subsequently, to ensure *the deal* is not only concluded but is successfully implemented to achieve both parties’ objectives.

Whether your firm is a potential buyer or seller, does it have a plan for its future?