PETER SCOTT CONSULTING

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Why merge?

Any law firm contemplating some form of consolidation (whether you call it a merger, sale or acquisition) should keep in mind two guiding principles:

- ***It is a means to an end*** *– for example, to build a more competitive law firm able to take on and beat rivals, or it may be a means to providing an exit for some or all of the existing owners.*

- ***It is however only the beginning, not the end of the process!***

There are two factors in particular which are leading to increasing consolidation of the market.

1. The need for profitable focused growth

Law firms are not immune from the need to take steps to safeguard their long term futures, which will depend on being able to continue to provide their clients with the value for money legal services they require. These firms need to grow in a profitable focused manner to provide the resources of expertise, finance, and infrastructure now needed to become competitive. The legal market is excessively fragmented to such an extent that around 80% or more of firms are too small to compete effectively or be viable from an economic standpoint.

2. The need for succession

Small firms face 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.

1. Firms seeking profitable focused growth

To ensure a firm will be **in the right place***,* strategic planning for a firm's future direction and growth requires continuous research, analysis, planning and decision – making – and is **client driven**. Planning for a firm's future should begin with a process of analysis of both external and internal forces exerting influence or control over a firm, followed by decision – making based upon that analysis.

Clients of law firms perceive that many are lacking sufficient resources to compete with their larger and more developed competitors, and feedback from clients often reveals there to be a clear distinction between the kinds of work they would give to a firm, and what would go elsewhere. Reasons for using another firm often include the following:

- *specialist expertise or knowledge not available at the firm;*
- *larger deals go elsewhere where greater resources are available than are perceived to be available at the firm;*
- *The 'IBM' factor, particularly where outside stakeholders are involved and the reputation of a 'bigger' name is needed for reassurance*

Feedback such as this highlights the ability of larger firms to develop **greater resource.** Lack of resource is a particular problem for firms in what might be called the 'middle market' Such firms cannot be all things to all men and being **focused** on a more limited number of areas of work or sectors at which they are good and for which they are known, using their relatively limited resources, is likely to be a more sensible and successful way forward in the longer term.

In today's competitive legal world having sufficient breadth and depth of expertise requires building teams in focused areas but building those teams is dependent upon having the necessary **financial resource** and concentrating investment in those areas where it can be most successfully and profitably applied.

The purpose of building a stronger platform for growth should be to **future proof** a firm by focusing on those things which will be future drivers of competitiveness and those areas identified as risks to the business, so as to **maximise owner value**. Markets are changing fast and only by continuously questioning the validity of the status quo and adjusting as necessary will firms be able to successfully respond to the powerful forces impacting on their businesses. Doing nothing cannot be an option in today's aggressive and ever more competitive legal services markets.

At the same time, law firms now require a minimum level of support infrastructure to be able to operate safely, compliantly and efficiently. Too many firms are still unable (or unwilling) to spend what is required to meet this minimum level of infrastructure in areas including management, finance, business development, knowledge management, HR, technology, risk and compliance.

Where firms cannot see their way **on their own** to filling the gaps in their expertise or infrastructure and, recognising that **scale** is required if a stronger resource platform is to be developed, merger then becomes a means for them to build that **stronger platform for focused growth** to compete with larger and more developed firms. Achieving this should 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 has now become not only a high priority for law firms, but a mandatory requirement.

Set out below are questions which may help you to better understand whether you have a need to profitably grow your firm and if so to decide whether some form of merger or acquisition may be an approach your firm should be considering.

NEED TO MERGE?	YES	NO
Are you unable to improve profitability because your firm lacks economies of scale and efficient use of people or other resources?		
Do you in a planned and methodical way **listen** to clients, prospective clients and referrers of work about: - How you are perceived in the market place? - Any capability gaps and improvements needed to your service? - Their legal needs in the future? - Your strengths and weaknesses compared to competitors?		
Do you currently have a clear, achievable and resourced plan to plug any gaps in your ability to provide clients with what they want from you and to ensure continuing		

client satisfaction and loyalty? OR Is a lack of financial or people resource preventing you from filling those gaps in your client service offering?		
Are you now in the right place in relation to your strategic focus and are your existing strategic plans realistic and achievable within given timescales?		
Have you concluded that you will not be able to achieve your realistic strategic goals on your own?		
Are you clear as to the strategic risks to the future of your firm?		
Has a client ever used a competitor firm in preference to you because you were not considered to have the necessary knowledge or expertise?		
Have you lost valued clients and good people to firms which are larger and more developed than your firm?		
Are there potentially profitable markets / areas of work or sectors which you have concluded you will not be able to access on your own?		
Do you have clients who individually each represents more than 5% of your turnover?		
Are you finding it difficult to *'stand out from the crowd'* and to create meaningful differentiation from your competitors?		
Are you unable to retain or to recruit the people you really want?		
Will succession be an issue for your firm in the next 5 / 10 years?		
Are you able to fully resource your support infrastructure needs, including - Finance - Business development - Risk and compliance - HR - Technology - Knowledge management		

If you currently do not have one, would a full time managing partner or CEO who is able to successfully build your firm's competitiveness and profitability, be desirable and acceptable to partners?		
Are there any changes necessary in your firm which currently cannot be implemented because of your inability to have access to sufficient resources or for any other reasons?		

2. Firms with succession issues

Succession issues can drive mergers in a number of ways.

1. Acquisition opportunities

Succession issues in firms can create **acquisition opportunities** for other firms. An acquisition strategy, by which a firm will aim to acquire good clients, people and expertise from one or more small firms who may be looking for a 'lifeline', can be a realistic way of growing profitably and a good place to start is to identify firms which have succession issues.

However, it is **focused growth** which should be aimed for. Having an appropriate focus to its business is vital for a law firm as clients no longer want generalist law firms, but instead want to instruct firms which have clear specialisms appropriate to meet the needs of clients. 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 clients and people, enhancing the firm's reputation and building profitability?*
- *What is the quality of the people in the target firm, their aspirations as to future careers, status and remuneration?*
- *What is the target firm's claims and compliance record?*
- *What impact will acquiring the firm have on cash flow, both in the short and longer term?*
- *Will acquiring the target firm plug the gaps needed to be filled?*

2. For partners or sole principals in firms with succession issues

Partners or sole principals in firms with succession issues too often will 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.

Finding another firm to join may be the only realistic option. Partners in small 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. A sole practitioner or small firm should therefore work at building a competitive focus to its practice which is going to be attractive to other firms, and 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 may have something to sell**.

This is about **picking winners** and is likely to require forward planning perhaps many 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 but nothing more;

- On the other hand, if you are able to reduce or eliminate the dependence of your business on **your own** skills and labour for its continued well-being, and you can do this in a way which preserves its income and profitability so the business can continue without you then you may be able to realise value either immediately on a sale or more likely after a bedding in period linked to an earn out arrangement. Building a team around you is one way of ensuring that you can divorce your ownership from your day to day continuing operational involvement so you are able to walk away from the business.

- 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 'value', always take good valuation, accounting, tax, P I insurance and legal advice.

Whatever your situation, future proofing a law firm requires planning. **Do you have a plan for your firm's future?**