jomati consultants

The Legal Services Board

The Future of Legal Services – Emerging Thinking

June 2010

The severity of the recent downturn has inevitably distracted firms from the looming introduction of the ABS regime in mid 2011. However, if firms want to consider outside investment when the ABS structure becomes available they need to be thinking now how to attract outside investment, what they will do with any money raised and what they need to change to make themselves appealing to new investors.

It is important to appreciate that outside investors are professionals. They are constantly presented with a wide range of investment opportunities. They reject most of them. They are looking for well-managed businesses with a clear and credible strategy, who are capable of using any investment to generate significant profits for themselves and the investors. Such investors are likely to fall into two main groups. The short to medium term investors, primarily private equity houses, looking to achieve an exit within three to five years at an acceptable level of return. The exit may be achieved by a stock market flotation, a second round of private equity investment or their being bought out by the existing owners. Other investors may be looking for longer-term returns in a growth business capable of generating returns significantly greater than those available through holding, say, corporate bonds or commercial property. These investors may be focused on a high rate of return over a sustained period of, say, 10 years.

In either case it is likely that any outside investors will demand a higher return than that usually demanded by bank lenders. Indeed, it is the increasing scarcity of medium term bank finance that is causing many firms to consider outside capital.

It follows that a firm will need a clear and credible plan for the use of such capital. A "business as usual" approach is unlikely to produce a sufficiently high level of future return to satisfy outside investors. Furthermore, any disposal of part of the business for cash which cannot fund the coupon required is effectively a forward sale of the present and future partners income stream which creates a complex range of intergenerational issues that are likely to be extremely problematic.

Capital can be used in part to reorganise a firm, possibly by easing the route to retirement of baby boomer partners and thereby releasing future profits for younger partners and the investors (indeed with Capital Gains Tax at between 10% and 18% as against a top income tax rate of 50% this may be very attractive). It can also be used to develop a firm's profile and reputation whether by the smarter use of client facing technology, a war chest to fund mergers, team hires or lateral hires and geographic and practice group expansion.

Any use of outside capital needs to be the subject of detailed analysis of the cost and level of return and the timelines required. Outside investors will be intolerant of woolly thinking, inadequate analysis and over optimistic forecasting. Clarity and rigour will be required.

Linked to any investment, a firm will need to consider the extent it will use the discipline of outside investment as an opportunity to change its internal management. Investors will expect professional and accountable management, not only at board level but also in the head of the business functions such as finance, HR, operations, IT and business development/marketing. Many law firms, which for so long have enjoyed healthy profit margins operate in a way which would astound and deter many investors. The leaders of law firms and their boards will need a clarity of decision making processes and a focus on the likely returns on any investments that they will make. They will need, on a continuous basis, to re-examine the market they operate in, the processes they use, their pricing models and their cash flow and profitability forecasts. Such an approach is common in many businesses but relatively rare within law firms who up to now have generated relatively high financial returns often in spite of themselves. Linked to this is the whole concept of accountability across the organisation, including partners. Clear job descriptions, operational targets and metrics will need to be established with consequences for both success and failure. In very few organisations will a lockstep partner remuneration system survive such scrutiny. Investors will often expect non-executive representation on the board of the law firm. If this non-executive talent is used well if will help the firm's business model evolve and provide a useful catalyst for change.

This may sound very daunting. At one level it is. However the disciplines required and the capital available could produce providers of legal services that are able to grow and prosper in the more competitive legal landscape that we are likely to face. Indeed this more focused, professional and businesslike approach may produce substantial returns to the partners even after the relatively high cost of outside capital. These changes will take time to achieve and partners will need to be persuaded of the need for change. Many of these changes will be necessary to succeed in a more competitive legal market whether or not outside capital is required. Firms would be advised to start this process now as some firms are clearly starting to address these issues.

If this level of change does not appeal, and it will not be appealing to many law firms, it is still necessary to consider the implications of such a change by a major competitor. If such a well-run and well-financed competitor aggressively approached your 10 best partners what would be the result if just five of them left you. This is not fanciful. In February 2010, Allen & Overy took 15 partners out of the leading Australian firm Clayton Utz to establish its new Australian office. Such moves both domestically and internationally could become the norm if well run firms have investment war chests available.

In a changing market outside capital will play a role. Ignore it at your peril!

Tony Williams
Jomati Consultants LLP