Law firm IPOs – access to a money tree?

Tony Williams

In the United Kingdom over the last year a range of legal businesses have floated on the UK junior stock market (Alternative Investment Market or AIM). To date, they have been well-received by investors. As a result, these businesses are trading with a market capitalisation in a range of twice revenues plus and a price earnings ratio (P/E) in the late teens.

So why are these companies coming to the stock market and why are they being so well received? This article aims to answer these questions and to consider what legal businesses need to think about when considering a stock market flotation.

It does need to be appreciated that relatively few of the legal businesses that have floated can be described as typical law firm models and so there may be different drivers for these businesses than more traditional law firms.

Why float?

The reasons for floating on the stock market are varied but the key reasons are:

- *To permit certain of the owners to sell their shares.* The typical law firm ownership model operates on the basis of a tenancy – I came in with nothing and left with nothing but in the meantime received a share of the earnings of the business. An IPO disrupts that traditional model by crystallising ownership interests at one point in time and enabling the owners to monetise their ownership interest. For those partners, especially at a senior level, an IPO can be very attractive. Not only does it produce a cash sum but it does so tax efficiently. Law firm earnings are generally taxed at a top income tax rate of 45% plus National Insurance and certain disallowable expenses giving an effective tax rate of about 48%. Conversely, on a sale of shares, capital gains tax will apply at rates from 10% (if Entrepreneur relief applies) to 20%. For those who have a significant interest in the business, the amounts achievable and the applicable tax rate can be a very appealing combination. It does, however, need to be appreciated that typically about 20% to 30% of the shares will be sold in the IPO with the balance retained by the former partners. They may then be subject to further lock-in provisions that limit their ability to dispose of shares in the future (Gateley had three-year and five-year lock-ins). Accordingly, in order to realise the full value of their shares they will need to be comfortable as to the medium-term prospects for the business.
- *To gain more profile for the business.* Not only will the IPO itself gain profile for the business but its six-monthly reporting of results will (hopefully) demonstrate its continued success and direction.
- *To project itself as a modern business aligned to its clients.* Some see the partnership model as outdated and closed whereas a listed company is required to be more transparent. Accordingly, the advocates of IPOs claim that this is a more modern image that the clients can relate to. Indeed, in a number of IPOs clients of the business have been happy to invest in the shares being sold.
- *To incentivise staff.* Although some firms have adopted staff bonus schemes, generally the profits of the business accrue to the owners. Following an IPO, the business can introduce staff share option schemes and employee share ownership plans with a view to attracting, retaining and motivating key staff, not just lawyers, in order to align their staff's interests with those of the owners. Whether such incentives will adequately compensate those lawyers who felt they were on the partnership track will need to be considered.
- *To provide business rigour.* The critics of partnerships suggest that the management of law firms is relatively poor, decision making is relatively opaque and the roles that partners have as workers, directors and owners lead to poor performance. Conversely, they say a corporate structure provides a level of clarity – a clear board structure (including non-executives), clear reporting lines and

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- *To provide an additional currency.* For law firms looking to expand, the traditional approach has been to either incur bank debt or to increase partner capital. In a partnership structure, retaining profits is tax inefficient as such retained earnings are taxed at the partner's highest marginal income tax rate. In a listed company, the company has the ability to issue shares to fund expansion, whether by taking over existing businesses or otherwise. Furthermore, any earnings retained in a corporate business are only taxed at 19%. Clearly, discipline needs to be exercised when using shares to fund acquisitions as demonstrated by the disastrous acquisition by Slater and Gordon (the first listed law firm based in Australia) of the Quindell business which ultimately brought the business close to insolvency and resulted in most shareholders losing almost their entire investment.
- *The market is strong.* Stock markets are remarkably robust at present and in the current era of very low interest rates investors are searching for decent yields. Tax rates on capital gains are currently very attractive. As the current bull market is entering its 10th year and interest rates are starting to rise, some feel that, in valuation terms, now is the best time to float. It is unlikely that, whatever UK government is in power, capital gains rates will go significantly lower, but they could, especially if we have a Labour government, rise very considerably. So, for those considering an IPO, there may be a feeling that there will never be a better opportunity to do so. Institutional and other investors are attracted to the relatively stable business of a law firm, the fact that many have been able to grow revenues and profits over a sustained period and the cash generative nature of legal businesses which implies a relatively stable and high dividend stream. As a result, many of the IPOs have attracted some significant institutional investment.

Before considering the issues to ponder before launching an IPO, it is worth looking at some of the businesses that have floated.

Gateley was the first in June 2015. Since floating it has raised its revenues to about £84 million and pre-tax profits to about £18 million. In corporate terms it has been a great success, reporting steadily increasing revenue and profits every six months. It has made a handful of relatively small and well-focused acquisitions. In the last three years its share price is up almost 90% and it has a market capitalisation of about 2.25 times annual revenues. Gateley is perceived as a well-run, mid-market full-service law firm.

Gordon Dadds floated in August 2017 by way of a reverse takeover of an existing company. Gordon Dadds is an acquisitive business which has rapidly acquired a range of law firms and provides clear arrangements for the former partners to continue to generate income based on the work that they do but freed from the pressures of running their own business. It is a model very different from the traditional law firm model. Immediately before the flotation, Adrian Biles, the CEO, owned over 50% of the equity of Gordon Dadds. The share price has performed well since the IPO and has a market capitalisation of about 1.7 times annual revenues (however given its acquisitions revenues are likely to be rising significantly).

Keystone Law Group floated in November 2017. This business describes itself as a "challenger law firm" which effectively provides a platform for over 250 self-employed lawyers in return for retaining part of their fees. Immediately before the flotation two owners owned about 80% of the business. Since flotation its share price has performed extremely well, and it has a market capitalisation of about three times annual revenues.

Rosenblatt floated in May 2018. It is a primarily

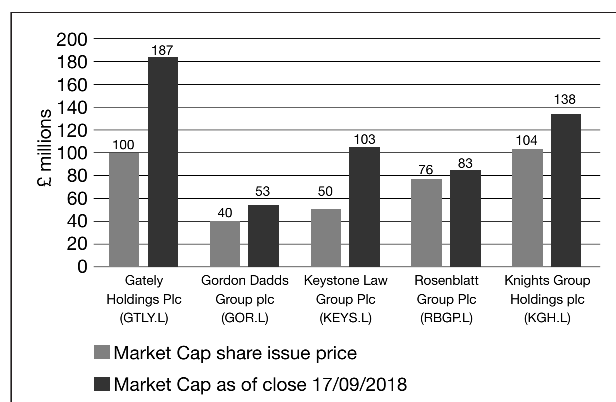
litigation and corporate law firm based in London. It does appear committed to developing alternative billing arrangements including litigation funding. Immediately before the float Ian Rosenblatt owned over 50% of the equity. It has also traded well since the float and has a market capitalisation of an impressive about six times annual revenues.

Knights floated in June 2018. It is a rapidly growing corporate and commercial law firm (including real estate, litigation, corporate and private client) which is based outside London. It has grown both organically and through acquisition. In 2012 it moved to a corporate structure via a management buyout (MBO) and attracted private equity investment. Immediately before the float David Beech the CEO owned 65% of the equity. Its share price has performed well since the float.

As previously mentioned, a common feature of the businesses that listed in the last year is the presence of a small number of key shareholders who have a particular incentive to obtain a price and market for their investment at this point in the business cycle.

Figure 1 below shows the movement in the market capitalisation since the date of the IPO.

Figure 1



Given the apparent success of the recent law firm IPOs, what are the challenges that are holding firms back? Again, there are a range of issues:

- *Structure*. If the business is not already a company, then before the IPO the partnership is usually sold by the partners to the company. In return for their partnership interest they receive shares in the company. There may also be an obligation to repay the individual partner capital account and to bring the partner current accounts up to date. There will also typically be agreements which provide a lock-in period so that partners' shares only vest or can be sold (in addition to any sold as part of the IPO) at a future date, say three to five years after the IPO. Some partners, especially at the relatively junior end, who will receive a limited allocation of shares may not be prepared to accept such a lock-in.
- *Allocation of shares*. The IPO requires an allocation of partnership interests to individual partners at a fixed date. For younger partners and those aspiring to partnership, such a crystallisation can be seen as selling the family silver or reneging on the implicit understanding that in the future the business will belong to them. In a traditional firm structure, finding a metric to allocate shares fairly between the generations of partners and establishing a pool, whether by share options or employee share ownership plans for younger partners, future partners and key staff, can be difficult or contentious. Inevitably, the younger partners may feel that the older partners, having already enjoyed the fruits of their senior status, are robbing them of their reasonable expectations. This may be less of an issue in a non-traditional business where ownership is concentrated in a few hands or in a more process-orientated business where the loss of individual senior lawyers may be less disruptive to the performance of the business, but for a firm that relies on a strong pipeline of top talent that is well motivated this can be an issue.
- *Remuneration*. In a classic law firm model, each year the profits of the firm are distributed in full to the partners in accordance with its remuneration system. In a listed company the dynamics are different. In order to maximise the profits of the business and thereby maximise its stock market valuation, the fixed remuneration of the partners needs to be as small as possible.

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Accordingly, partners will receive four types of income: first, their fixed share salary; second the dividends on the shares they are allocated on flotation; third any shares allocated to them via share options or otherwise; and fourth the sale proceeds of shares when they sell them. The attractiveness of this package will depend on the number of shares initially or subsequently allocated to them and the performance of the share price. Under the old model, 100% of annual profits go to the partners. In the new model, the partner receives a base salary plus dividend flow. But if the company sells 30% of its shares in the IPO and distributes 70% of its profit (Gateley undertook to make such a distribution) the dividend available for the former partners will be 70% × 70% = 49% of the company's after-tax profits. Accordingly, if the income a partner receives as salary is relatively small (and bear in mind that the company will be paying National Insurance contributions of 13.8% of income and this does not apply to a partnership), it is possible that the combination of base salary and dividend income will be less than the partner would have received prior to flotation. Dividends, which are paid after corporation tax paid by the company, are generally less tax efficient for higher rate taxpayers than a partnership profit distribution. This income shortfall will be mitigated by any proceeds received at the time of the IPO or subsequently when the various lock-in periods expire and shares can be sold, and by the fact that these payments should be subject to capital gains tax rather than income tax. Accordingly, a former partner will be very anxious if the share price does not perform as expected. Indeed, if the share price falls a partner may decide to move elsewhere and forfeit his or her shareholding rather than remain locked in to an uncertain future income level.

- *Transparency.* As a listed company the legal business is required to issue half-yearly financial results and to keep the market advised of any price-sensitive developments. There are likely to be non-executive directors on the board and a level of structure as to reporting and decision-making. Although the former partners may be significant shareholders in the company, they may have less influence over the direction and strategy of the business. Some may accept this as the price of achieving a capital gain, others may find this apparent lack of control and autonomy stifling. This may particularly be an issue for high-performing lawyers who tend to jealously try to control their own destiny.
- *Lock-in.* As mentioned above, lock-in arrangements will often apply to the vesting and sale of a partner's shares. An issue could arise when such lock-ins expire. Will the former partner sell up and either move to another firm or retire? If this happens, what impact will it have on the continuing business? Again, for a business relying on highly rated practitioners this could be a significant issue. As mentioned, a significant share price fall may mean that a former partner would rather take a role elsewhere than wait for his or her shares to be sold.
- *International*. England and Wales is one of the few jurisdictions to permit the non-lawyer ownership of law firms. For firms with a significant international footprint this could produce challenges. Although verein type and other structures may be available to mitigate this, there would still be cultural and operational challenges in moving from a 'one firm' model to something more complex and potentially looser. There may also be major differences in the tax treatment of the proceeds of the flotation for partners in jurisdictions outside the United Kingdom.

Conclusions

For a legal business where a small number of people own much of the equity, the current appeal of an IPO is obvious. Indeed, these may be the most benign market and tax conditions for such owners to realise their investment.

In relation to a more typical firm where ownership is widely spread across a range of partners of different

ages and with different career aspirations, the issue is more complex. The legal market is gradually consolidating, technology is and will have a profound impact on the delivery of professional service and client expectations are changing. Some will argue that the disciplines of a corporate structure together with clarity of ownership and the ability to retain earnings will make a listed company more able to respond to such a dynamic market. Others with equal vehemence will argue that the partnership structure works well, is flexible and robust and provides a mutuality of interest of those operating in, running and owning the business that provides powerful incentives and a common interest. They also point to the fact that the large management consultants such as McKinsey and the Big 4 accounting firms despite their size, brand positioning and business acumen have not pursued the IPO model.

Clearly, for many law firms the arguments will be finely balanced but any who want to shake the money tree must remember that there are consequences of doing so.

Tony Williams is a principal of Jomati Consultants, the leading legal sector strategic and management consultancy which advises law firms and legal departments of all sizes across the world. He was previously managing partner of Clifford Chance and then Andersen Legal.

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