Time to fix the roof while the sun shines

By Tony Williams
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Preparing your firm for a crisis

In June 2007, my colleagues and I wrote an article for the Gazette (What goes up…, 21 June 2007) warning law firms to prepare for a downturn. Little did we realise then how severe and long-lasting the ensuing financial crisis was going to be. Inevitably, we were treated like the host closing the drinks cupboard in the middle of a good party and most firms objected to our negativity and ignored our advice. Now, with many UK law firms reporting record revenue and profit performance for 2017/18, is it time to revisit our earlier advice? At the risk of, yet again, being seen as a party pooper, I think we should.

At a macroeconomic level, a range of amber warning signs are flashing. US interest rates are rising steadily; the US is reversing quantitative easing by selling or redeeming $25bn of assets a month (rising to $50bn a month from September); the interest rate on short-dated US Treasuries may soon exceed that of longer-dated securities (a very reliable indicator of an impending crisis); president Trump appears intent on stoking trade wars with China and the European Union; emerging markets' debt and equities are under strain; Argentina and Turkey have seen currency meltdowns; liquidity is reducing in many major markets; corporate and personal debt levels are high; tech stocks are at highs not supported by revenues or profits; and the current equity bull run is entering its 10th year (the S&P 500 Index is up almost 400% and the Nasdaq 100 up by about 650%). Locally, we are facing an uncertain period in the run-up to Brexit with a strong chance of a new prime minister and even a new government in the next 12-24 months. We have not yet had the chancellor proclaim the end of 'boom and bust', but even a raging bull would have to acknowledge that there are speed bumps ahead for the global and UK economies.

So, what should law firms do, to quote George Osborne, to fix the roof when the sun is shining? Here are 10 steps that can be taken.

People

Inevitably, when firms are busy there is pressure to recruit and retain partners and staff to do the available work, to keep revenues and profits rising. But firms still need to be realistic. Rigorous reviews need to be undertaken to identify partners, lawyers and professional staff whose performance is not up to standard or who are in areas that cannot achieve an acceptable level of return for the firm.

Dealing with poor performance now not only improves the morale of others who are working hard, but also positions the firm in the event of a slowdown. Poorly performing practices or offices may be capable of being sold or transferred to other businesses. Individuals who are to be counselled out are far more likely to achieve alternative roles in the current buoyant market.

Such action may have some minor impact on immediate revenue or profit, but acting now will be cheaper and less disruptive for the firm in the medium-term.

Recruitment
Law firms traditionally employ full-time staff to produce their anticipated budget revenue for the year. As wages have increased (especially in London, where US firms have significantly increased salaries) this works well when the lawyers are fully utilised, but high lawyer salaries and high leverage can rapidly impact on profitability if work levels reduce. Firms need to consider if some of the current increase of work can be handled more flexibly. There are a range of services providing experienced and pre-vetted lawyers and paralegals on an as-needed or project basis, such as Lawyers on Demand for lawyers and F-LEX for paralegals. Other firms use their alumni network and other programmes to provide flexibility. The ability to use good-quality people at variable rather than fixed costs can be attractive at this stage of the business cycle.

Working capital
Law firms have a long-term problem in terms of turning work in progress into bills and then bills into cash. Often 120 days (a third of a firm's annual revenue) is tied up in work in progress and debtors. Better partner discipline and systems can result in significant improvements. Simple steps sound like common sense, but are rarely consistently done. These include adhering to the terms agreed with the client; keeping within scope for fixed-price work and immediately agreeing with the client the cost of any variations; agreeing the fee with the client before the bill goes out, when working on a monthly billing cycle; billing the client at the start rather than the end of the following month; understanding the client's approval processes and payment cycle; and undertaking credit checks before working for a client.

As a result of a casual approach to billing and revenue collection, many firms needlessly erode their profit margins, so getting best practices adopted now will enhance current and future performance.

Debt
In an era of low interest rates and relatively loose credit, accumulating bank debt can appear a cheap and easy way to fund working capital. But it needs to be remembered that bankers are happy to lend you an umbrella when the sun is shining, but want it back when it starts to rain.

Bank debt is appropriate to fund the peaks and troughs of the cashflow cycle, and significant investments such as new premises or office locations. Any firms with significant debt should certainly not be taking on more to fund partners' drawings. Developing a plan to amortise debt to sustainable levels and to extend the maturity of banking facilities will give the firm extra headroom if markets turn down.

Partner capital
When partners are receiving record profit shares it is appropriate to consider increasing the level of partner capital. As profits rise partner capital may have reduced as a percentage of earnings. This needs to be re-examined. Banks are willing to provide partner capital loans on competitive terms. Increasing partner capital to reflect the rise in revenue and profit makes sense, as the larger the business the greater its need for working capital.

Remuneration system
In the last few years a range of firms have reviewed their partner remuneration systems. This is far easier to achieve when profits are rising, as the revised system can apparently produce far more winners than losers. The reverse is true if profits are falling. Developing the right remuneration criteria and performance metrics takes time but can provide further tools with which to manage in a downturn.

Other costs

Firms are generally much better run than before the last downturn. But there is always room for improvement. Do we have strong and effective procurement processes? Are our professional support areas functioning well and do they have clear objectives and performance measures? Do we have the right financial and practice management systems in place? Are we using IT effectively in the delivery of our legal services to protect and enhance our profit margin? Are we making the best use of our premises? Do we recover all client disbursements? All these questions need to be addressed while the firm is doing well.

Clients

It is easy when you are busy to take your clients for granted. So, it is necessary to understand who are your key clients and the introducers of work to your firm. Time will need to be taken to keep close to them and to demonstrate the value that you give to them. In a downturn some firms will engage in suicide pricing just to keep the lights on. The stronger your relationship with your clients, the less tempted they will be by such special deals.

It may also be sensible to understand which of your clients may be specifically affected by a downturn, not only so that you can help them through any crisis but also to minimise your credit risk to them.

Pricing

Many firms now do much of their work on a fixed-price basis. The SRA will shortly require firms to publish pricing data in relation to certain areas of work. But does the firm sufficiently understand the effect of fixed pricing on the amount and profitability of the work it does? Are partners too ready to discount already discounted rates? Have they been properly trained for pricing negotiations? Have they considered different ways of delivering their service which achieve a higher profit margin? Is your pricing consistent with the market or, if at a premium to the market, can you rationalise that premium in terms that the client will understand and accept?

Poor pricing decisions combined with poor billing practices can unnecessarily erode the profit margin of a firm.

Getting good pricing disciplines embedded now will not only improve a firm’s current profit, but provide some level of protection in the future.

Strategy

Be clear what clients you want, what work you want to do for them, your price point and your client proposition. The last few years have been benign for law firms. But a rising tide lifts all boats and can obscure a lack of effective strategy.

An ability to focus investment and effort in key areas of long-term growth and to articulate why clients should use you will be essential in what could be more competitive markets. Recently, many firms have considered potential mergers, but rejected them because they are doing fine. It is far better to contemplate a merger when you have a range of credible options available to you and it is all too easy to assume that the status quo is the safest option.

Some merger propositions do not make sense, but others potentially have a very strong business case. Integration is easier in a strong market. Should any merger options be reconsidered now, while you are in a position of relative strength?

The sun is shining, England got to the World Cup semi-finals for the first time in a generation and it is holiday time. All good reasons to do nothing. But, while there is still time, get up and fix the roof.

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