

Legal Week

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Dial M for merger

Stagnating turnover in a mature market is forcing many UK firms to revisit the merger option, despite the considerable hurdles, says Tony Williams

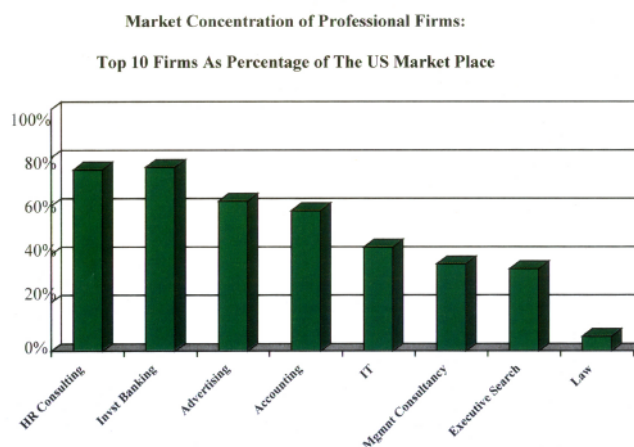
The last few years have seen precious little domestic merger activity among mid-sized UK firms. The most recent exception was the merger between Addleshaw Booth & Co and Theodore Goddard to create Addleshaw Goddard. But even in that case Theodore Goddard had been in play for a few years and had come close to merger on at least one previous occasion.

There has been more activity between US and UK-based firms, but they still only account for about one transaction a year — the last two being Mayer Brown and Rowe & Maw and Jones Day and Gouldens. However, albeit from a low base, there are the initial signs of increased activity. Two US/UK deals are currently in the public domain. Kirkpatrick & Lockhart is likely to merge with Nicholson Graham & Jones and DLA is in the final stages of its negotiations with Piper Rudnick.

In addition, national firm Pinsents is looking to expand its London capability by a merger with Masons, which will create a top 15 UK firm. Other discussions are continuing at various levels of intensity and many are more than just a twinkle in the managing partner's eye.

Within the US there has been far more merger activity, particularly among the smaller firms, as lawyers have started to provide a credible capability in many of the larger US business and financial centres. Indeed, the second stage of consolidation appears to be occurring, with a number of mid-sized US firms contemplating merger. The most recent example of that trend is the merger of Wilmer Cutler and Hale and Dorr. However, generally law is still the most unconsolidated market in the professional services sector (see chart).

Law Firm Consolidation



Source: Edge International

Traditionally the barriers to law firm consolidation have been:

- **Lack of economies of scale:** once a firm achieves a basic critical mass it was thought that there were few obvious economies of scale. Indeed, the extra 'management' required for a larger and more diverse firm was seen by many as a diseconomy of scale.
- **Conflicts:** conflict rules make it very difficult for firms in the same market to merge as the risk of actual legal client conflicts, especially in litigation, and commercial client conflicts (where clients in one industry object to you acting for their competitors) are substantially increased by size. In a larger firm the identification and resolution of potential conflict issues takes up a material amount of senior lawyer time.
- **Client demand:** many general counsel stated that they instructed individuals, not firms. They claimed to be unimpressed by a firm's capability outside its home office, especially if the client had established law firm relationships in the other locations.
- **Culture:** firms express deep commitment to their 'unique' culture. They are worried about losing that culture or, even worse, having an alien culture imposed upon them. Accordingly, firms seemed prepared to take over another firm but not to merge to create a new and potentially more dynamic culture.
- **Money:** the profitability of firms can vary materially even in similar sectors or locations. The manner of calculating and distributing such profit may also be very diverse. The possibility of short-term earnings dilution or the difficulty of integrating divergent remuneration systems is a major impediment to a merger.
- **Partnership approval:** in many firms to approve a merger requires a high majority of the partners to vote in favour. Accordingly, partners threatened by the merger may effectively have a veto right. This favours those who wish to maintain the status quo unless the status quo is even more threatening than the prospect of the merger.
- **Integration costs:** in the short term, mergers will often be earnings dilutive as there will be the costs of implementing the merger. IT integration, redundant premises, staff and partner rationalisation and firm rebranding can result in substantial costs. Traditionally, firms expense these costs as they arise, hence many suffer a short-term fall in profits, especially if the market is static.

Given all these problems, should firms even be considering a merger option? Well, quite simply, the market is changing and many firms are now actively considering a merger as a way to achieve or at least advance their strategic aims. Although the barriers to merger should not be underestimated, it is unlikely that law firms will be able to avoid the pressures that have driven mergers in all other sectors of professional services for too long.

The new or at least more evident trends that will induce greater merger activity are as follows.

Panel reviews

Clients have at last woken up to the fact that lawyers are service providers. Accordingly, they are applying many of the procurement techniques applied to their company's other suppliers. This is manifested by the establishment of preferred suppliers (following panel reviews),

whereby a smaller number of suppliers are often given a closer relationship in return for a more comprehensive and cost competitive provision of services. With many clients moving from, say, 15 to five legal suppliers this enhances the position of larger well-regarded firms able to invest in the client relationship and to provide a range of high-quality services often from a variety of locations.

Maturity

The legal market grew rapidly during the 1980s and most of the 1990s. The downturn in the UK over the past two years has shown the turnover of many firms stagnate. Although some upturn can be expected as the economy improves, it is unlikely that in the medium term we will see firms as sold out as they were in 1999 and 2000. This is likely to place considerable pressure on medium-sized firms without a differentiated high-quality client offering. Growth of fee income is more likely to be achieved at the expense of the firm's competitors rather than general market growth. Growing and maintaining market share in key practice areas will become increasingly important. Therefore, firms will need to adjust to more mature markets with lower levels of annual fee growth. This is a particularly important issue for lockstep firms that need profit growth of at least, say, 5% per annum to allow partners to move through the lock step without diluting the value of a partnership unit.

Such maturity will cause firms to consider merger as a means of developing and protecting their market share, especially given the consolidation of legal advisers referred to above.

Economies of scale

Admittedly, there may be few obvious economies of scale in the practice of law. But there are some and they can be important. New client-buying habits makes lawyer efficiency much more important, especially for fixed-price or capped work. Accordingly, investment in effective IT, know-how and training is important. A larger firm should be able to get the same service at a lower cost per head than a smaller firm. Alternatively for the same price a large firm should be capable of producing far superior services in these areas than a smaller firm. Also, significant investment in client relationship management, branding and new offices and service lines will cost less per partner in a large firm.

Lateral hires

Lateral movement of partners is now an established fact in the UK market. It is also looking increasingly likely that we will start to see more teams of lawyers moving firms. This means that the best 20% of a firm's partners, who often generate or are responsible for more than half of the firm's turnover and profit, are more valuable than ever. Larger firms are more able to invest in lateral hires, are likely to pay more and will have a client base and range and depth of skills that make the hire more likely to succeed. A firm that loses some of its leading partners risks falling into a vicious circle of decline, while the hiring firm can lock into a virtuous circle of development.

None of these factors take into account either the growing success of some of the larger US firms in the London market or the possibly seismic impact of the potential Clementi reforms. Greater, more commercial and mass-branded competitors may emerge.

Additional capital may become available from investors to fund the development, by merger and otherwise, of the most successful firms. As long as firms view that the status quo is maintainable, there will be little serious demand for merger activity among mid-tier law firms. However, with turnover stagnating and market share under pressure, the status quo may become a less comfortable and less sustainable option. A loss of a couple of major clients or of a couple of significant partners may reduce a firm's turnover by 10%. This may have the effect of reducing a firm's profitability by 30%. For a law firm, like any other business, to maintain a static position in the medium term is difficult. Firms are either improving or declining as compared with their peer group. Without a clear strategy and effective management, short-term 'stability' can very quickly turn into long-term decline. As in any business, there is no pre-ordained right to succeed or to maintain a pre-eminent position. For example, of the 100 FTSE companies in 1984, only 40% were still in the FTSE in 2004. Of the survivors, more than half had substantially changed by way of merger, demerger or fundamental reorganisation of their business. Unfortunately, many law firms will only realise that these business rules also apply to them and that the status quo is not maintainable when they face major shocks, such as the loss of a major client or the departure of some key partners. By this time their options and negotiating position will be severely limited.

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