

Managing a law firm: Survival of the fittest

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Make no mistake, law firms are in for an extremely tough 2009 — but that doesn't mean there won't be opportunities, say Tony Williams and Colin Ives

With many major professional services firms reporting impressive half-year revenue increases we could be forgiven for thinking that those in the legal profession will escape the worst effects of the economic downturn. However, this would be a naive and dangerous approach.

Those recording increases of revenue in the first half have benefited from three factors: a flight to quality in a crisis to magic circle and other top firms, an international presence (as most overseas markets have slowed down later than in the UK) and sterling's devaluation against the euro and the US dollar. Some UK-based firms have also benefited from having a practice that is not dependent on property, M&A or finance work. But even for these firms the outlook is uncertain, to say the least. Most firms do not expect to repeat their first half performances in the second half of 2008. For purely UK-based full-service firms it will be prudent to assume that fee income will be 5%-15% below that recorded in 2007-08. Some firms have already taken active steps to reduce their costs — from cancelling Christmas parties to implementing formal redundancy programmes. This looks set to continue and accelerate during the coming months.



It is a concern that so few partners in professional services appear to appreciate the effect that a relatively small downturn can have on partner profits. In a boom market, the leverage model delivers high profits; in a bear market it produces high cost and under-utilised resource.

The chart shows the impact of a 10% and 15% reduction in fee income. As can be seen from the example, a 15% drop in turnover can, in some firms, equate to a 50% fall in profit per equity partner (PEP). In the short term, most costs are fixed

IMPACT OF REDUCTIONS IN FEE INCOME

	2007-08	2008-09 turnover down 10%	2008-09 turnover down 15%
Turnover	£25m	£22.5m	£21.25m
Profit	£7.5m	£5m	£3.75m
Net margin	30%	22.20%	17.64%
Profit per equity partner	£375,000	£250,000	£187,500
No. of equity partners	20	20	20

and a redundancy programme often takes at least six months to produce any cost savings, causing a negative cash flow effect in the interim.

Relatively modest reductions in turnover have a major impact on profitability, but a reduction in turnover is not the only concern that firms will face. With deals taking longer and often collapsing at a later stage due to the lack of bank finance, many firms have significant old work in progress (WIP). Much of this will not prove to be billable. Furthermore many issued bills will either not be paid or will be heavily discounted to extract payment from the client.

Using the example in the table, if the firm writes off 3% of its revenues against doubtful WIP and provides a similar 2% provision for bad debt — both of which are relatively modest in this market — PEP will reduce to £193,750 (in the 10% revenue reduction scenario) and to £134,375 (in the 15% revenue reduction scenario).

For management accounting purposes, many firms are now providing 10% against WIP and debtors over three months old and 25% or more in respect of WIP and debtors over six months old. In a downturn, WIP and debtors rot very quickly as they age. Firms should also be wary of the long-term loyal client whose outstanding fees and WIP are increasing. The ‘don’t worry, they always pay’ may change to ‘they can’t pay’.

There must be a substantial chance that smaller firms heavily reliant on residential conveyancing or secondary commercial property will make no profits at all this year. Many will not survive. Even among the top 100 UK law firms, there will be outfits where profit per equity partner is reduced by more than 50%.

So what should law firms do? The first thing is not to panic. Knee-jerk decisions are likely to destroy the value of long-term projects and damage confidence in the management team. The second thing is to make sure partners and key staff focus on what the firm actually does: practise law. They must also be clear on their roles in helping the firm to weather the storm. Realistic budgets and cash flow projections covering a range of scenarios need to be prepared, and shared. Costs need to be rigorously contained and preferably reduced.

For most firms the highest cost item is people, which may make a targeted redundancy programme necessary. It is necessary to identify the people at all levels in the firm you still want to be with you in three years time. Keep them busy and motivated. The rest may be expendable. Various supply contacts can be re-tendered to try to reduce costs. But one of the higher costs items — premises — is usually fixed in the medium term.

Banks are now very reluctant to lend, so cash will need to be carefully conserved and billing and collections procedures strictly adhered to. Clients will understand the benefit of holding onto cash so will need to be pushed for regular payment. Their payment delay is an interest free loan from your firm for which your bankers will happily charge you interest. Some firms are already encountering billing and collection problems. If numbers of combined WIP and debtors increase, then, without rigorous control, this problem could balloon and the firm will run out of cash. Firms rarely fail due to a lack of profits; a lack of cash is a different matter entirely. Combined with lower profits, firms may need to defer partner distributions or make partner capital calls, placing further pressure on individual partner cash flow.

Law is traditionally a lagging indicator of the economy. However long the technical recession lasts, firms need to assume that the legal services recession will continue for at least 12 months afterwards as clients regain confidence and rebuild their balance sheets, as was the case in the early 1990s. Accordingly, a rigorous medium-term business plan based on a thorough understanding of the financial dynamics of the business will be essential. This should enable the leadership to take measured and proportionate steps consistent with preserving and enhancing the long-term value of the business.

But in the midst of all this gloom there will be real opportunities for well run, cohesive and strategic firms. Laterals, teams and merger opportunities will arise. Firms will need to proceed with caution and undertake extensive due diligence (and not just rely on the head hunters’ selling story). Most opportunities will be dismissed, and rightly so. But if the right opportunities are grasped, the firm will emerge stronger and better placed than its competitors when the economy finally recovers. Indeed, the Addleshaw Goddard and Berwin Leighton Paisner mergers in the early part of this decade show how good deals in a downturn, effectively implemented and integrated, can help to positively reposition a firm.

Unfortunately, some mergers or other moves will not be strategic or well implemented and may just result in a larger, more troubled firm. One particular issue to consider on mergers or team hires is the potential for the acquirer to assume successor liability for the professional indemnity claims of the acquiree. This is potentially a major poison pill and needs to be identified early in order for its potential effect to be minimised. Client, practice, cultural and financial due diligence will also need to be rigorous to avoid nasty surprises.

The next couple of years will test the leadership, cohesiveness, management systems and strategy of all firms. Many will fail on more than one count, and if they survive some will be much diminished. This downturn, which will be followed by the full implementation of the Legal Services Act, will be a major accelerant for change and consolidation in the legal profession. For firms that have good leadership and hope for the best but prepare for the worst, this period will represent a golden opportunity. But opportunities are rarely taken if you are holed up in a bunker.

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