

Beware of the upturn – why firms still need to be careful in good markets

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As the results for 2014-15 show a sustained if gradual improvement in law firms financial performance, together with the news of Gateley's successful IPO it is tempting to assume that the worst is now behind law firms after a gruelling period following the financial crisis. However, law firms need to be wary of the upturn and ensure that their firm is well placed to weather the storms that will buffet the legal market for many years to come.

In our view there are six factors that law firms need to pay particular attention to if they are going to survive and thrive over the next few years.

Cash

Firms have increased their long term debt (over one year) from £5.75bn in 2010 to £7.35bn in 2014. Conversely short term debt, mostly overdrafts, has reduced from £2.4bn in 2011 to £1.8bn in 2014. Firms have however received a very significant cash infusion by way of the estimated £1bn of capital injected by fixed share partners to meet the recent requirements of HMRC.

Banks still see law firms as a relatively good risk but a few high profile failures may see credit committees becoming far less accommodating and the cost of facilities rise. Crucially the capital injection from fixed share partners many firms benefitted from last year will not be available this year, at a time when arguably there will be an even greater need for cash than before.

Any upturn produces pressure on a firm's cash position as it hires more staff, while WIP and debtors increase. Many large firms are now waiting as long as 150 days to turn their work into cash which puts massive strain on their cash flow. This is an increase on previous years' lock up days and is a worrying trend which applies to law firms of all sizes.

Banks are unlikely to increase facilities if they are required due to poor working capital controls or to pay out cash to partners. Partners can be very lax in both billing and collection so rigorous systems are needed to ensure that working capital is closely controlled.

Notwithstanding the protestations of partners, experience shows that unbilled time and uncollected bills become far less recoverable the longer they remain unbilled or outstanding. Effectively managing cash flow is now even more of a key priority for law firms.

Partners

A hotter legal market gives partners (and associates) more choice about the firms to join and makes successful firms more acquisitive. Accordingly, the best partners (and associates) are at risk especially if a firm does not have a clear and compelling story which encourages people to stay.

As the market improves acquisitive firms are prepared to make more financially attractive offers to partners and associates. Indeed, some firms are already reporting difficulty in recruiting three to five year PQE associates.

Key partner defections are particularly difficult to deal with as more firms are increasingly reliant on the billings of a few successful partners or teams. Partners can not only take major client relationships with them but also, as we saw with the demise of Halliwells, require their capital to be repaid,

therefore increasing pressure on cash flow. The departure of only one or two high performing partners can leave a firm in a very vulnerable position that may not easily be fixed by lateral hire replacements.

Costs

Legal salaries are at last outpacing inflation and most firms' revenue growth. Premises costs are also increasing, especially in London. US firms are paying up to £100,000 for newly qualified associates and the magic circle are paying over £70,000, forcing other firms to increase their salaries or risk losing good quality and hard to replace associates.

Meanwhile rents in Central London are increasing significantly with West End office space now at over £100 per sq foot and other areas of London catching up quickly. All of these costs are fixed in the short term so firms need to grow their revenue and, importantly, their lawyer productivity, just to absorb these additional costs.

As salaries and rent account for most of a law firm's costs these trends, if they continue, will place real strain on finances. The current trend for law firms to introduce flexible working policies and invest in technology is not going to immediately help deal with existing expensive 15-20 year lease obligations.

Margin

Costs are rising but pricing pressure, and especially the move to fixed pricing, is putting real pressure on profit margins. In firms of all sizes we are seeing many cases where revenue per lawyer is static or declining despite some upturn in the level of hours recorded.

It is very unlikely that many clients will accept significant increases in hourly rates or fixed fee arrangements so there is real pressure on firms to "work smarter" to protect and enhance their profit margin.

Many larger firms have developed onshore low cost execution centres in order to re-engineer how their more routine work is done. There will be a short term cash requirement to set up such centres but benefits should follow in future years.

It is however unclear how smaller firms will respond to this development as they lack the resources to develop their own low cost centres or the volume of work to make such centres viable. Those firms that cannot change their operating model face lower margins and lower profitability which will further reduce the funds available to revise their operating model. For some this may result in a death spiral.

Competition

Despite the relative upturn in activity, competition at all levels of the legal market is intense. Clients know they can shop around and significantly reduce their legal fees. It is very unlikely that client behaviour will change as all business costs (including legal fees) are under increased pressure in virtually every business sector.

The ABS regime has produced many new entrants. PwC, KPMG and EY now each have ABS licences and appear likely to significantly expand their legal offering over the next few years. PwC has already set its sights on being a top 20 global legal services business within the next five years and has recently posted an annual UK turnover of £41m.

Accordingly, for a firm to grow it will not only have to cope with its existing competitors but also with new entrants often using very different business models. As a result, to survive, a firm will need to be clear how it will defend its market share and indeed take market share from competitors.

To do so it will need a clear and compelling proposition for its current and target client base which it is able to consistently deliver while achieving a sustainable profit margin.

Currently very few firms have a clear, compelling and distinct proposition which is sustainable in an increasingly competitive market. There are approximately 9,500 law firms registered in England and Wales down from 10,362 in 2009. This shows that the long talked about consolidation of the legal profession has already started to happen.

The key question is whether this downward trend accelerates at a time when the economic outlook is more positive than it has been since the onset of the financial crisis.

Complacency

The period since 2009 has been tough for many law firms. Increases in revenue and a sense of recovery may cause many firms to relax but the problems exposed during the downturn have not gone away. These include underperforming partners, poor risk management processes, an outdated partner review and remuneration system or practices or offices that are no longer aligned with the firm's strategy.

Banks may be relatively relaxed about their exposure to law firms and the SRA has recently reduced the size of its specialist team which deals with firms in financial distress but is this a cause for comfort or concern?

Firms need to be clear which section of the legal market they are focused on and why clients will use them. Additional hiring or mergers may need to be considered to enhance depth and market position.

We have seen relatively little UK/UK merger activity in the last couple of years except where one of the parties was encountering a level of distress. Given the cost and competition pressures, more merger activity is to be expected.

Firms currently seem to be entering into discussions with an unrealistic, even rose tinted, view of their medium term prospects thereby underestimating the potential benefits of a merger.

This is not to suggest that a merger is a panacea but any merger opportunity should be considered objectively and realistically as it may provide a stronger and more robust platform for future growth while reducing the cost per partner of any necessary investments. Conversely, badly thought out or poorly executed mergers may put the future of a firm in jeopardy.

Standing still in a market subject to so much change will be a dangerous option for most firms.

The signs of a sustained recovery in the legal market are welcome. However the legal market has changed for good. It is more competitive and becoming increasingly efficient in the delivery of legal services.

This will inevitably produce winners and losers as we enter the next stage of evolution of the market.

Despite a period of sustained low interest rates many firms have come through the last five years with increased levels of debt, and partners have increased their personal exposure via their partner capital loans.

The recovery will bring its own challenges and many firms may not be in a strong financial position to rise to them. Those who have hoped for a recovery for six years may need to be careful what they have wished for.

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Available online: <http://www.legalweek.com/legal-week/opinion/2426732/beware-of-the-upturn-why-firms-still-need-to-be-careful-in-good-markets>