Strategies for survival, strategies for growth

Law firm finances have been making headlines for the wrong reasons. A further crunch point came in November 2013 when a worryingly high number of firms across England and Wales were unable to secure professional indemnity insurance and face potential action from the SRA. This latest in a run of bad financial news for many firms confirms that a tipping point is being reached across the legal industry. The impact of changes in legislation, restricting referrals, changing fee structures and the calculations of costs, are now also coming through the business cycle to hit fees and profitability. For many firms the combined impact of these developments is creating a well-founded sense of urgency.

Whilst the challenging economic climate has hit many firms hard, there are now these other factors coming together to place additional strain on law firms' traditional operational, financial and business models. Regulatory developments including the Jackson Review of Civil Litigation and the Legal Services Act are reshaping the commercial legal sector. A combination of technological developments and outsourced business models are enabling some routine high-volume, low margin work to be carried out in low-cost offshore jurisdictions by new types of legal service provider. Overall, the legal sector looks to be undergoing a transformation that is structural rather than simply cyclical.

In this first paper we consider some of the very timely and pressing business, operational and financial challenges, as well as the opportunities, that EY's extensive experience in the legal market highlights as the most urgent that firms, and their stakeholders such as funders and regulators, will need to address as they move forward in a fast-changing market.

Look out for our next legal sector insight papers in the coming months, which will consider how to best manage the conflicting interests of key stakeholders, how legal practices can evolve to ensure they remain fit for business and what opportunities exist for those practices with funds available for investment.
A market in transition

The Solicitors Regulation Authority (SRA) recently reported\(^1\) that a high proportion of firms it surveyed were facing significant financial stress, with more than 30 of the largest 200 firms in the UK in financial difficulty. In its report the SRA pointed to a number of practices associated with firms facing financial difficulty. These include: an inability to measure or control financial performance, excessive use of borrowing, weak processes for collecting on bills and inadequate planning and due diligence for acquisitions of other firms.

Those challenges accord with EY’s experience of working with clients across the legal sector. Where we have been helping firms in turnaround, for example, we are often seeing problems that have arisen from high fixed costs as a result of expansion strategies that made sense in the boom years. These are accompanied by declining revenues as a consequence of both general economic conditions and over capacity in the market. On the other hand, we have worked with many firms that have weathered the storm and are now exploring the opportunities to grow and capitalise on market conditions.

Our work in the sector highlights that all key stakeholders, i.e., law firms, lenders and regulators, need to ask some vital questions about the approaches that will secure the best outcomes for all parties.

► Lenders may need to review in detail their overall understanding of their clients’ activities and funding in order to achieve clarity on risks and the information needed to robustly review current and future funding arrangements for the longer term.

► The Regulator is currently very active owing to widespread market stress and change and may need to ensure that it can access the right advice to achieve solutions that will balance the interests of firms and their lenders whilst protecting the clients of firms.

► Partners should be seeking to review and plan sufficiently in advance of any potential problems in order to maximise the flexibility and agility with which they are able to manage their businesses through potentially tough times.

\(^1\) Navigating stormy seas: financial difficulty in law firms SRA, November 2013
Some key issues to consider

EY has worked with a number of firms to help them reorganise and address stressed financial and business situations. None has become insolvent or resulted in regulator intervention. Our success in working with those firms has highlighted that any law firm in turnaround will have to address multiple issues, including organisational change, cash management, debt restructuring, strategies to retain key personnel, negotiations with funders and so on. Below we highlight some of the key issues we commonly encounter and their implications.

Regulatory change arising from the Jackson Review and the Legal Services Act:

► End of referral fees, pressure on revenues
► Changing costs regime
► New competition in the market for low-margin, high volume work
► New corporate structures with non-lawyer owners/investors create the potential for new corporate forms but raise cultural challenges

Funders’ shrinking appetite and withdrawal from the market at a senior, clearing bank level and also by secondary and tertiary providers of finance. Key consequences include:

► Partner time diverted to focus on managing funders rather than fee-earning and business development
► Increased pressure on cash
► Creditor and stakeholder management (e.g., HMRC, specialist lenders, retiring partners seeking to withdraw equity)
► Squeeze on working capital
► Unsustainable/damaging reduction in debt
► People and retention issues

Effective working capital and cash management require the development of specific capabilities including:

► Building in financial management awareness including into engagement letters
► Establishing ownership for financial management and creating formal processes, supported with appropriate technology, to communicate and manage ongoing costs of work in progress
► Understanding the benefits of improving working capital and implementing operational measures as well as coaching behavioural change to accelerate contract-to-cash performance
► Modelling of trading/performance data

Consolidation in the market looks set to continue. Issues for firms considering merger or funding options include:

► Conducting thorough market analysis to understand potential merger strengths and weaknesses and likely synergies
► Assessing robustness of revenues and strength of client relationships
► Considering key personnel and teams’ willingness to remain with a firm post-merger
► Understanding long-term financial commitments in terms of, for example, property
► Understanding the potential issues (e.g., exit timetable) that may arise from securing alternative external funding (e.g., private equity)

For some, the conditions today are shaping up as a perfect storm, for others they are creating opportunities to grow. But all firms need to ensure that their approach to financial management can evolve to take account of a marketplace that has significantly changed. Whether they are considering a merger or are working through a process to address financial stresses, having the optimal approach to what EY call the Capital Agenda is critical.

Coming soon!

Look out for our next legal sector insight paper in early 2014.
Why EY?

EY’s Transaction Advisory Services has extensive experience of working with law firms, funders in the sector as well as regulatory bodies. Our advice and services help each of them to address the challenges arising from a fast-changing legal market.

Whether assisting a firm in turnaround or working with potential merger partners to achieve successful integration, our experience spans the full range of business, financial and operational issues that law firms and their stakeholders will need to consider as they adapt to the new realities of the legal market.

Our proven track record

Our experience and knowledge of the legal sector is highlighted in the following examples.

**Project Gold**
Client: £25mn turnover law firm
EY provided operational restructuring, modelling and debt restructuring advice, managing negotiations with stakeholders following cash shortfalls. A successful refinance was agreed with core lenders on a sustainable basis.

Size of debt: £20mn

**Project David**
Client: Law firm
EY completed pre-acquisition due diligence as part of an accelerated distressed sale process.

Target: UK law firm with £10mn turnover

**Project Tavinor**
Client: Lending bank
EY provided a review of working capital facilities and assisted with a successful turnaround of the business and refinance.

Target: £15mn turnover multi-office law firm

Size of debt: £5mn

**Project Momentum**
Client: Lending bank
EY evaluated the firm’s current performance across divisions, assessing newly implemented IT systems in order to drive working capital improvements and reduce WIP write off and reporting accuracy.

Results: Realised an improvement in working capital equivalent to 3% of revenues, over 12 months and improved monitoring and reporting tools.

**Project Apple**
Client: Lending bank
EY performed an independent business review of a distressed law firm, enabling the bank to deleverage.

Target: Midlands law firm

**Project Club**
Client: International property management firm
EY completed pre-financing due diligence in respect of a capital contribution to a tenant.

Size of investment: £20mn

Tenant: International law firm with £200mn turnover

**Project Snow**
Client: International property management firm
EY completed pre-investment due diligence in respect of a principal tenant.

Tenant: UK-wide law firm with £100mn turnover

**Project Blue**
Client: Global Professional Services Firm
EY evaluated the firm’s current performance across divisions, assessing newly implemented IT systems in order to drive working capital improvements and reduce WIP write off and reporting accuracy.

Results: Realised an improvement in working capital equivalent to 3% of revenues, over 12 months and improved monitoring and reporting tools.
The Capital Agenda

EY’s Capital Agenda provides a framework that can help law firms to address many of the challenges they face – as well as the opportunities. At the same time, using the Capital Agenda can help funders, regulators and Partners to understand the specific financial conditions impacting law firms and use those insights to develop strategic responses to provide constructive support.
Your EY contacts

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About EY
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