Pathways to growth: reaping the rewards from recovery

Our recent papers on the legal sector have largely focused on the challenges that many firms face as they adapt and respond to tough economic conditions and a fast-changing legal market. But there is another, more positive side to the story. Accordingly, this paper considers areas for firms in the market wishing to acquire or to position themselves for sale.

In addition, even firms in robust financial health will still need to negotiate a market that is undergoing a period of profound change. Disruption in the legal services market is coming from many directions and in many guises. Technology, new forms of finance and business structures, international competition, non-traditional entrants to the market and a changing regulatory regime are all playing their part to reshape the market. In EY’s view, the firms that win in this fast-changing environment will be those that successfully address a wide range of strategic developments and have internal discipline. There is much to play for.

Going for growth

A glance at the headlines in the legal press suggests that there are greater grounds for optimism than the market has seen in a long time. Many firms have announced rising profits per partner. Merger activity is being driven by ambitious growth plans, succession planning, exits and survival. While funding has further tightened in recent years, there are growing opportunities arising from new forms and sources of financing, acquisitions and a need to pursue transactions to build competitive advantage in a fast-changing legal services landscape.
There are many examples of firms pursuing aggressive expansion strategies before, during and now after the financial crisis. For example, the world’s largest business law firm today, DLA Piper, completed a number of mergers with firms across the world over the last five years to secure its globally leading position. Firms from outside tier-one, such as Australia’s Slater & Gordon, have also executed a series of sizeable, targeted transactions to secure rapid international growth in line with clearly set strategic goals. Of course, size alone in terms of the number of fee-earners and offices, is far from being the whole story when it comes to building a successful, competitive firm. A number of key factors need to be considered as critical components in any pursuit of sustainable growth.

**Spotting the opportunities; finding the synergies**

The drivers behind a merger or acquisition can be as diverse as the firms involved. Targets for acquisition or merger will typically be selected according to their ability to meet one, or more, of the following criteria:

- New clients to achieve greater penetration. Many firms are looking to add complementary teams to boost their position in a specific market. For example, the Australian listed firm Slater & Gordon, has used its access to capital to make a string of acquisitions in the UK that fit its aim of becoming the largest consumer law firm in the UK. As has the private equity-backed Parabis Group in the insurance claims market.
- Client retention — by strengthening key practice areas and ensuring sufficient scale and international reach to provide services in line with clients’ growth and changing expectations.
- Diversification — acquisitions in specialist areas or in key geographies can help a firm to expand its opportunities and tap into new opportunities.
- Profitable revenue from carefully targeted acquisitions of firms or specific practice teams.
- Succession planning — internal candidates may not offer the solution and partners need to search elsewhere.
- Viability concerns — addressing a shortage of new matters; skill sets, compliance issues, etc.
Growth across borders

Firms increasingly operate in a global market of clients that is worth an estimated $300bn per annum.¹ Yet no single law firm has a greater than one percent share of that market. The business logic of international expansion, affiliates and consolidation is therefore powerful, and firms have sought to pursue it in a variety of ways. There have been a number of transatlantic mergers over the past few years, but other territories are also likely to become active in their search for broader international reach and client base. Firms are also no longer simply following their clients into particular jurisdictions, but are examining targets that will enable rapid growth and/or that offer a sound strategic fit.

While we’re some way from seeing the same global strength and depth of the ‘Big four’ accountants’ networks in law firms, these are starting to appear. Law firms are likely to seek more affiliates or possibilities to build global networks in order to provide integrated services to their clients and to access new developing markets, such as China, e.g. UK firm’s SJ Berwin’s tie up with the Asia Pacific focused firm King Wood Mallesons.

New players

The changing shape of the legal market is also creating space for new players and driving merger and expansion strategies. Initially, it will be the smaller, general practice firms that might feel the impact of the low-cost, high volume operators looking to enter the market for routine legal services. In response, we’re likely to see a continuing consolidation of smaller firms to achieve the critical mass and economies of scale that are going to be required to provide high volume, relatively low value legal services.

However, changes in the market will provide other opportunities for firms that are nimble and agile to operate at higher-value and more specialised ends of the legal services spectrum. Not only is established talent at traditional firms becoming available to ambitious and innovative new legal providers, niche firms are also arising that are challenging larger firms in highly specialised areas of practice.

Technology

The impact of digital technologies is also creating many new opportunities. Not only does technology change how law can be practised, it can dramatically shift the cost base and create new business and financial models for firms that are prepared to embrace innovation. Cloud computing, for example, creates possibilities for shifting certain, more routine, workloads to dispersed, lower cost locations and personnel. While concerns about security and data privacy have restricted their use to date, advances in encryption will enable firms to use cloud computing to change how they provide services and to create direct online services for clients. Increasingly, services higher up the value chain will also be provided through new channels. For example, a number of bespoke firms have already started offering transactional advice and consulting from ex-Magic Circle partners that operate from a platform structure very different from the high-cost operations of large city firms. Of course, it’s not only those in today’s profession that will have that opportunity.

While predictions about the fully ‘virtualised’ law firm may still be some way from realisation, there’s no doubt that aspects of that model are emerging. Advances in mobility, for example, are creating more flexible ways of working that the profession has been slow to adapt to but which clients are increasingly likely to demand. The internet is radically changing the shape of many different sectors — from healthcare to entertainment — and the provision of legal services is by no means exempt from the internet’s impacts. Many in-house legal departments, for example, expect to be able to track the progress of matters and billing online, and are pushing their providers to automate and digitise manual and paper-based systems. Firms that embrace the technology to deliver will likely achieve significant competitive advantage.

Law firms’ internal systems are also growing in sophistication, enabling more accurate and reliable analysis of profitability and productivity. Technology adoption will become an increasingly important factor driving not only internal efficiencies, but also competitive differentiation and new ways to engage with and deliver to clients.

¹ “Sir Nigel Knowles: Legal M&As an ‘imminent certainty’”, The Evening Standard, 03 February 2014.
New legal structures – new possibilities

Alternative Business Structures (ABS) allow for non-lawyers to be able to own and manage law firms. The change in regulations also means that funding from non-traditional sources, such as non-partner private equity – or even a public market listing – is now possible. While the number of ABS firms remains a relatively small proportion of the overall body of legal firms in the UK, the impact they are creating in the market is significantly larger. Businesses from outside the traditional legal market are establishing or buying legal providers, often to provide services related to a principal brand or activity, such as personal injury from an insurance business. EY, for instance, worked with one of the first private equity-backed firms in the UK, Parabis Group, that is developing a considerable market presence in insurance claims processing – and it’s a strategy that we expect to see developing in other areas.

Private equity investment example: Parabis and Duke Street

The investment in Parabis by private equity house Duke Street shows how a business with a distinct business plan and a new approach to legal services is able to attract investment in order to drive a clear growth strategy and develop a new approach to delivering legal services.

Parabis has built a thriving business, focused on the insurance market, though a combination of organic growth and acquisitions. By building a clearly differentiated proposition for its customers, the firm has carved a clear niche and now intends to further develop its business with expansion into new channels and market segments and by developing a BPO model that will leverage the efficiencies available from lower cost offshore locations.

The development of new structures and access to sources of funding opens up possibilities for existing firms as well. The ability to create new service providers that bring together complementary business services under one common ownership structure is already being developed to provide end-to-end advisory services in areas such as insurance, with claims administrators, specialist insurance lawyers and loss adjusters all working as one business. The ability to bring in outside capital and new approaches should also create new possibilities that will enable new firms operating as an ABS to challenge the status quo in areas of practice that have hitherto been the preserve of specialist firms. We’re also seeing the revival of the multi-disciplinary professional services practice concept – with business advisory and financial services firms adding legal services to provide end-to-end services. As they pursue those strategies, firms need to make sure they reflect and accommodate the changing needs of their customers – and build propositions that will deepen their appeal as a service provider to a clearly defined and well targeted customer base.

Tax – attractive options?

The adoption of ABS structures will also change the tax profile for law firms and partners. However, the ability to move from traditional partnership taxation to corporate rates needs to be approached with some caution. Comparing the headline rates of taxation applying to partnerships (approx. 45%) against a 20% corporate tax rate makes incorporation appear to be an attractive option. However, additional personal taxes on distributions to equity holders mean that the overall level of tax for a company’s owners could end up at the same rate or higher as partners currently pay. What’s more, timing of the transition may result in simultaneous tax payments (personal and corporate) on conversion. But each case will be different. If there are international elements to a firm’s structure, these should be taken into account when thinking about the tax structure. And the conversion from partnership to limited company status may also offer some attractive tax planning options. But the clear message is that each firm needs to review carefully its unique circumstances and proceed with a comprehensive view of the tax merits or otherwise of changing its legal entity status.
Ready to go? Exit readiness diagnostic

Exit readiness is EY’s approach to helping firms identify the issues that can maximise the value available from a divestment of all or part of their business. By combining the perspectives of experts in key areas including financial, operational, commercial, tax, IT, HR and performance management, the Exit readiness diagnostic can help surface and address any issues or risks that may impact on a potential sale. By assessing any potential deal from a bidder’s/buyer’s perspective and by understanding the market context, the Exit readiness process can expedite the sales process and identify the key issues that may impact deal structure, process and value.

EY research demonstrates that a strong focus on exit will generate value. By taking a comprehensive approach to sizing up a possible divestment, EY helps firms to avoid common pitfalls such as failing to understand the needs of specific buyers, effective communication, effective planning, evaluating a portfolio effectively and ensuring value is not lost between completion and signing.

Top three questions for exit preparation

1. What is the impact of the current transaction market on the potential sales process and expected buyers?
2. Can the track record be modelled in sufficient detail and does it bridge to the forecast in a way that provides the right level of evidence, despite the increased market uncertainty?
3. Is there a detailed road map sequencing critical path items, timeframes, responsibilities, etc?

New funders, new approaches

As noted in our previous papers, the approach of traditional lenders to the sector has changed over the last few years. However, with the development of new forms of financing, we are seeing partnerships exploring new options, with sources such as debt funds and private equity looking closely at the market. As partners approaching the end of their careers seek to exit, there are opportunities arising for new funders to acquire a stake and private equity is making development capital available for those firms that have a clear business plan and a strategy to execute in a specific market space.
Looking forward

As changing legislation continues to reshape the legal market itself, new opportunities will continue to emerge. We envisage a large volume of transactional activity among small, medium and large firms. Some will drive for global scale and comprehensive services offerings, while others will seek to develop niche areas by focusing expertise and bringing in experts from disciplines other than law to create innovative propositions. No firm can avoid the multiple disruptive influences that are reshaping the legal market with unprecedented force. But there are significant rewards available to those firms that develop and execute a clear strategy for growth.

EY continues to be active in this space and has a record of achieving the desired outcomes that benefit the firm and its stakeholders. We would welcome the opportunity to assist you, and to bring our experience to help you maximise opportunities in this changing market.
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