

Financial strategy for law firms

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Howard escaped from Grant Thornton UK LLP in 2008 where he had been a partner for over 25 years to establish his own boutique practice. During his time at Grant Thornton he was head of professional practices for the North West and head of family businesses for the UK. At Grant Thornton he had a variety of roles including office Managing Partner, North West regional marketing partner and membership of the partners appointments panel. Howard specialises in advising mid market professional practices and family businesses. In 2002 he won the CBI's national award as "Best Business Adviser“.

Howard's focus is providing "special projects" advice to firms with up to 20 partners. His experience extends from highly profitable sole practitioners to advising 3 of the top 100 law firms. Recent assignments have included sales of law firms, partnership disputes, fund raising, LLP and ltd company conversion, ABS conversions, sales and acquisitions.



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Barry Wilkinson helps medium-sized Law Firms, to improve their business performance, helping successful ones grow turnover, profits and client loyalty, and turning round the “stressed but not distressed”

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Agenda

- Strategic direction
- Structuring
- Making more from less
- Mergers & acquisitions

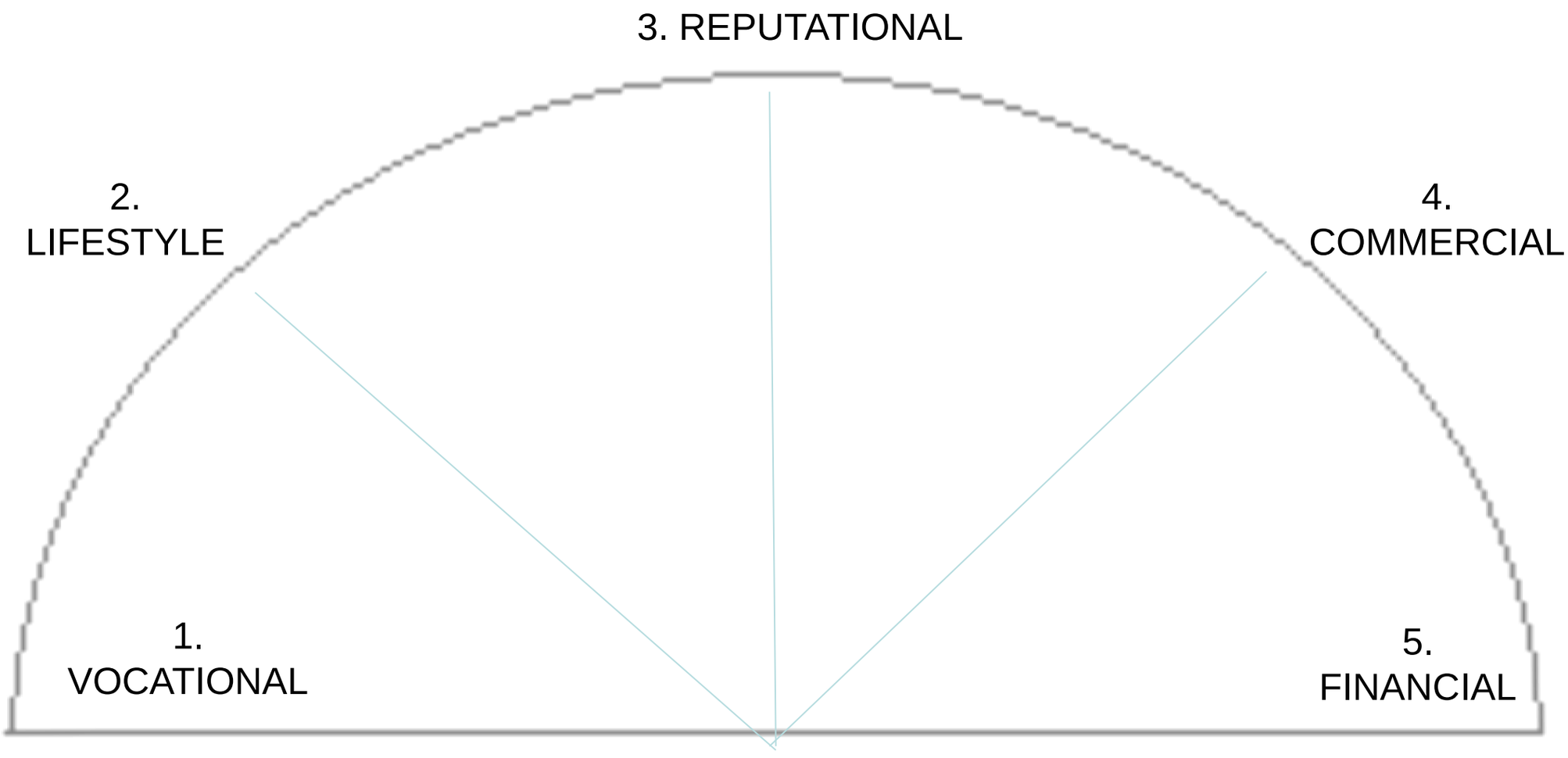
Strategic direction

Objectives Drive Strategy….

- What is our objective?
  - Capital Growth
  - Profit Extraction
  - Something Else
- Strategy Drives → Measurement and Management
- But CULTURE (Purpose?)EATS STRATEGY FOR BREAKFAST - Peter Drucker



Professional Service Firms Spectrum of Purpose



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If you sell your firm , the buyer will move it to the right anyway, so maybe you should make the change yourself????

Growth or Extraction?

- PLC – Stock Market Valuation
  - Share Price x No of shares
  - Forward Looking, subjective
  - Based on Multiple of Earnings
  - Multiple reflects QUALITY of Earnings
  - Reflects Growth Potential

- Law Firms
  - Profit per Equity Partner
  - Backward Looking, objective
  - Reflects Extraction Potential
  - Can Create Funding Issues



Professional Service Firm Business Models What is your client buying?

		What kind of work are you doing ?	
		Familiar, execution- intensive assignments	Frontier, customised, One of a kind assignments
What relationship does THE CLIENT want?	High degree of Client contact. Client wants results AND interaction	Counselling **NURSE**	Diagnosis **FAMILY DOCTOR - G.P (Trusted Advisor)**
	Low degree of client contact. Client focuses on results only	Efficiency **PHARMACIST**	Creativity **BRAIN SURGEON**

From David Maister – The Trusted Advisor

Brain surgeon

Metric

- Volumes
- Charge Rates
- Price Sensitivity
- Transaction Values
- Leverage
- Key Skills
- Market Source
- Legal Examples
- Equity Value

Profile

- Low
- High
- Low
- High
- Minimal
- Technical
- Professional Referral
- Litigators
- Nil

Structure - Probably Tax Driven?? Extraction Oriented

Pharmacist

Metric	Profile
• Volumes	• High
• Charge Rates	• Low
• Price Sensitivity	• High
• Transaction Values	• Low
• Leverage	• High
• Key Skills	• Management (Process, IT, Sales, Risk)
• Market Source	• Database, Website, CMC Referral
• Legal Examples	• Conveyancing, Debt Coll, PI
• Equity Value	• High (if profitable)

Structure - Probably Corporate – Capital Growth Oriented

Examples of Pharmacy Type Legal Work

Someone Other than Client Pays –Relationship Irrelevant

- Re-mortgaging – Lender Pays
- Legal Aid - Government Pays
- RTA Portal -Insurer Pays

Transactional Work, Client Pays, can be Price Sensitive

- Residential Conveyancing
- Commercial Debt Collection
- Simple Wills

Structuring

Structuring

LLP or Limited company

Limited company – pros and cons

Advantages

- Recognised vehicle for M&A activity
- Relatively low set up and operational costs
- Potential goodwill extraction if sale to 3rd parties
- Retained profits taxed at corporate rates – to repay borrowing
- Better structure for share incentives
- Better understood for true ABS

Disadvantages

- Inflexible succession planning
- Administration & documentation
- Benefits in Kind regime – particularly cars
- Potentially expensive:
  - NIC costs
  - PAYE
  - NIC
  - Cash flow
- BUT New dividend tax rules

Tax position – tough call

	Remuneration		Dividend	Interest or rent	LLP	
	40% full NI	40% lower NI	32.5%	40%	40% full NI	40% lower NI
Profits	1,000	1,000	1,000	1,000	1,000	1,000
Remuneration	(879)	(879)				
Employers NI at 13.8%	(121)	(121)				
Interest on directors loan				(1,000)		
Subject to corporation tax	0	0	1,000	0		
Corporation tax at 20%	0	0	(200)	0		
Dividend paid	0	0	(800)	0		
Profits retained	0	0	0	0		
Personal income	879	879	800	1,000	1,000	1,000
Income tax	(351)	(351)	(260)	(400)	(400)	(400)
NI	(105)	(18)	0	0	(90)	(2)
Net proceeds	422	510	540	600	510	598
Effective tax rate	57.8	49.0	46.0	40.0	49.0	40.2

Ignores - £5,000 dividend allowance and Class 2 NI

Other tax issues

- Tax on profits retained on exit

	CGT	
	20%	10%
Retained profits	1,000	1,000
Corporation tax at 20%	(200)	(200)
	800	800
Less CGT	(160)	(80)
Net proceeds	640	720
Effective tax rate	36	28

- Tax on incorporation
  - CGT & Stamp Duty – relief if same before & after
  - Release of overlap relief
  - Goodwill "trick" no longer available unless sale to 3rd party
- Will dividend extraction be attacked?
- Potentially no employer NICs for fixed share partners
- Pensions - Ltd able to control income for restriction of £40k relief if > £150k
- No Employment Related Securities for new partners in LLP
- Difficult to go back tax efficiently

Summary

- LLP or Ltd no brainer v unlimited partnership
- No simple answer
- What is important? Flexibility v. Incentivisation
- Tax marginal
- Rule of thumb
  - LLP if draw out all profits
  - Ltd if significant borrowings to repay



Structuring

Ownership and capital

Value – the starting point

- See mergers section below
- “Real” Goodwill
  - Less likely in collegiate practice (brain surgeon/GP)
  - Often excluded as between partners
  - But likely to have real value in process driven firm (pharmacy)
  - Difficult to fund
- “WIP” goodwill = contingent WIP
  - Often off balance sheet – watch FRS102 – back to the future
  - Usually taxed on exit at 10%
  - Has real value but what is it?
  - What is fundable – firm & individual



Partner capital



- Need to distinguish between types
  - Fixed = ownership stake/share
  - Current
  - Tax provision
- Current account to be freely withdrawable
  - So sufficient bank facilities needed
  - Fixed capital set sufficiently high
- Fixed capital often borrowed personally (off Balance Sheet)
- Tax provisioning policy – complex but highly recommended
- Property ownership
  - Whole session in itself
  - Seriously consider use of series of SIPPs
  - Cash out and property at 40/45% discount
  - Align partner interests with that of the partnership

Points system – capital and “dividend”

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5
Partner 1	100	100	100	100	100
Partner 2	60	70	80	90	100
Partner 3	100	90	80	70	60
Partner 4	0	0	50	60	70
	260	260	310	320	330

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5
Partner 1	38.5%	38.5%	32.3%	31.3%	30.3%
Partner 2	23.1%	26.9%	25.8%	28.1%	30.3%
Partner 3	38.5%	34.6%	25.8%	21.9%	18.2%
Partner 4	0.0%	0.0%	16.1%	18.8%	21.2%
	100.0%	100.0%	100.0%	100.0%	100.0%

Gearing

- The ratio of external funding (bank) to partner capital
- Primarily a banking issue
- Is also a partner risk issue
- Banks rarely lend > one:one
- Security - varies but 30% to 50% debtors & WIP



- Debt to fee income < 40%
- Personal Guarantees??!! – try to limit and avoid joint and several and supported
- Interest cover – at least 2 times but less used
- Others but vary from bank to bank

But what if geared?

Fixed assets	75,000	75,000	75,000
Current assets			
Contingent WIP	0	300,000	300,000
WIP	500,000	500,000	500,000
Accrued income & debtors	635,000	635,000	635,000
Disbursement debtors	75,000	75,000	75,000
	1,210,000	1,510,000	1,510,000
Current liabilities			
Trade creditors	10,000	10,000	10,000
Bank borrowing	**500,000**	**500,000**	**800,000**
	510,000	510,000	810,000
Net current assets	700,000	1,000,000	700,000
Net assets/Partner capital	775,000	1,075,000	775,000
Partner capital	**775,000**	**1,075,000**	**775,000**

RT & Co LLP - implications

	Alice Arnold	Brian Barlow	Cathy Clarke	David Dawes	Edward Eagle	Total
Profit share	20%	25%	15%	20%	20%	100%
Points equivalent	80	100	60	80	80	400
Existing capital	150,000	250,000	75,000	150,000	150,000	775,000
WIP uplift	60,000	75,000	45,000	60,000	60,000	300,000
	210,000	325,000	120,000	210,000	210,000	1,075,000
Revised capital	215,000	268,750	161,250	215,000	215,000	1,075,000
(Contributed)/drawn	(5,000)	56,250	(41,250)	(5,000)	(5,000)	0

Revised capital	215,000	268,750	161,250	215,000	215,000	1,075,000
Bank borrowing	(60,000)	(75,000)	(45,000)	(60,000)	(60,000)	(300,000)
Geared capital	155,000	193,750	116,250	155,000	155,000	775,000
(Contributed)/drawn	(5,000)	56,250	(41,250)	(5,000)	(5,000)	-
Bank funded	60,000	75,000	45,000	60,000	60,000	300,000
Capital movements	55,000	131,250	3,750	55,000	55,000	300,000

Structuring

Profit sharing

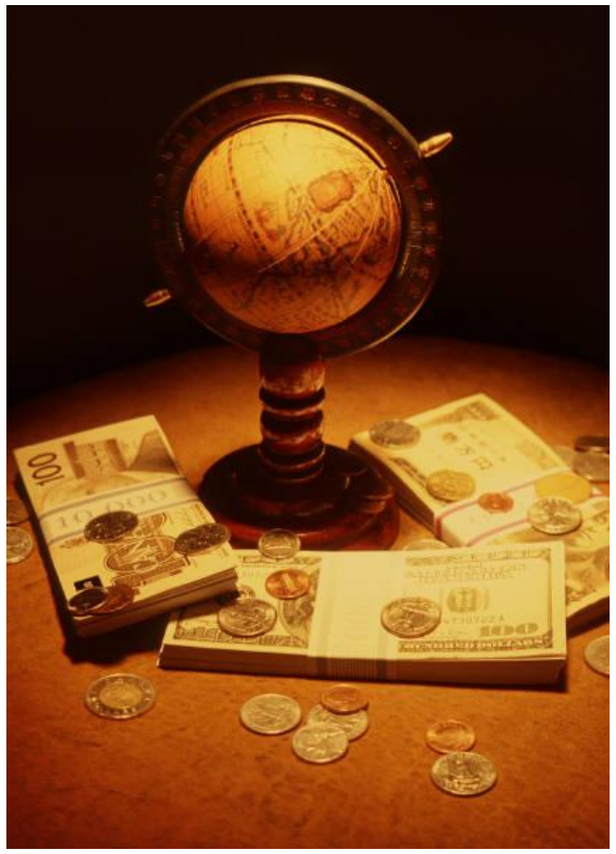
Profit sharing theory

- Equality via lockstep
- On performance
- A mixture of the two
- Drawings policy
  - Linked to anticipated profit share & realistic forecasts
  - Regular monthly amounts (like a salary)
  - Surplus drawn after accounts available



Our preference (probably)

- Interest on capital – allows borrowing & compensates for unequal current accounts
- Rate for job/fixed prior share
- Performance pool – **BUT** divisive
- Dividend based on points
- Possibly departmental/geographic pool



Making more (profit) from less (funding)

What could go wrong? SRA (Lack of) Viability Indicators

- Drawings in excess of profits
- Borrowings in excess of net assets
- Heavy dependence on high overdraft borrowing
- Inability to measure or control financial performance
- Over dominant senior/managing partner
- Lack of transparency of financial performance
- Narrow focus on single type of work
- Weak billing & cash collection processes

The three legged stool and role of profit



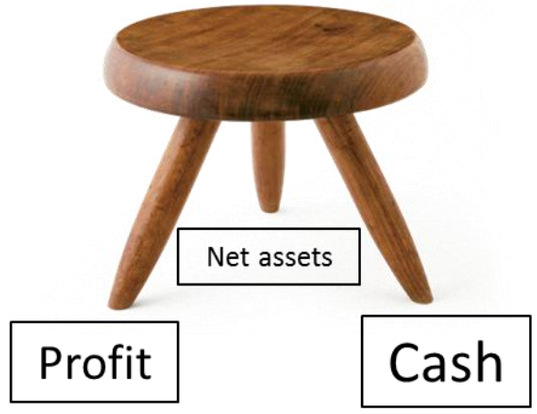
- Every major law firm that failed has had plenty of profits right up to the moment it collapsed
- Businesses do not fail because of a lack of profit, they fail because of a lack of cash

Ed Reeser Blog, November 2013

Profit & Loss Account for Median LMS Firm

	%	
Fee Income	100%	
Operating Costs		
Fee Earners	44%	Fixed – Short & Med Term
Secretaries and Direct Support Staff		
Other Support Staff		
Premises	33%	Fixed – Long Term
Professional Indemnity Insurance		Fixed – Long Tail
Marketing		Decision Cost
Bad Debts		Manageable
Depreciation		Fixed – Long term, Not Cash
Training		Decision cost
IT		Largely Fixed – Med term
Other Overheads		Many fixed, some variable
Partner Reported Profit	23%	
Being.. Notional Salaries & Interest	15%	
“Super Profit”	8%	

P&L – Costs Structure 2 Key issues - Board Level Decisions



- Flexibility (Lack of) means
  - You Need High Margins,
  - Low Break-Even Point
- Value for Money
  - It’s not what you pay – It’s what you get for what you pay
  - So we need to measure Overhead Effectiveness
  - Use Activity Based Analysis to understand

“It's unwise to pay too much, but it's worse to pay too little. When you pay too much, you lose a little money - that's all.

When you pay too little, you sometimes lose everything, because the thing you bought was incapable of doing the thing it was bought to do.”

John Ruskin

Professional Practice Pipeline - The Five-Stage Process of Creating Value



If you neglect the beginning the pipeline empties

If you neglect the end, all the effort is wasted

The Objective is to get from Instruction to Collection, in the shortest time, with maximum income and maximum client satisfaction

Be Careful What You Wish For - What Gets Measured Gets Better.....

Gross Profit – Time , Time and Time again

- Gross Profit
  - Income Generated (Price x Quantity)
  - Less Staff Costs - Include a notional “Salary” for Partners
- Is overwhelmingly a “Performance” Issue
- Can Be Affected by EVERY Fee Earner, Team Leader, Head of Dept, Partner….
- Pricing & Value Proposition
  - Confidence, Systems Process & Conversation, Options
  - Selecting Clients Willing and Able to Pay
- Time Capture - Complete, Accurate, Comprehensive
- Write Off Control - Often the Biggest Single Cost, and Invisible! Learn not Blame
- Upper Quartile Firms get >20% more from each Fee Earner → bottom line profit
- It still matters with fixed fees



Funding – Why and How Much?

- Funding Required for
  - Infrastructure / Capacity - Fixed Assets, People etc..
  - The Working Capital Cycle
  - “Lockup” = WIP, Debtors, Disbursements



- In most Law Firms, Lockup dwarfs Infrastructure
- The Shorter the Working Capital Cycle
  - The Less Funding is Required
  - One month out of the cycle would transform many firms’ Balance Sheets
  - **And has important by-products →**
- Most Client Complaints are about
  - Price
  - Communication
  - SPEED (Lack of)
- A relentless focus on time elapsed can also transform Client Satisfaction
- Which helps make staff less grumpy too!!!!

Delay outgoings??

Type of Creditor	Scope for Action
Disbursements	SAR
People - payroll	Nil?
Cost of sales (e.g. Referral fees)	Negotiable - Competitive
Property	Contracted and Predictable
IT Contracts	Limited after commencement
Prof Indemnity Insurance	Funded ?
Third Party Purchases	Mostly Contracted or low Value
Finance repayments	Contracted
PAYE & VAT	Nil ????????????????
Tax	Nil ?
Capital expenditure	Difficult, once committed
DRAWINGS	Usually a Last Resort

How much funding is needed – the difference in days

Turnover		6,000
	Days	Lockup £000's
LMS Overall Median	177	2,910
PI Firm LMS Median	480	7,890
LMS - 5-10 Partner Median	218	3,584
30 day improvement	147	2,416
Cash generated with 30 days improvement		493
In three partner firm per partner available to draw		164

Making it happen

- Biggest impact – dampening the cycle

Week	→	Day
Month	→	Week
Quarter	→	Month
Year	→	Quarter

- Hearts & minds – stick & carrot – use of KPIs reported to everyone

- Friday afternoon question?
  - Its about priorities
  - And comfort zones



Mergers & acquisitions

Strategic intent

- Why should you merge?
  - ONLY if it improves profit
  - OR at least protects it
  - Less than 50% really successful
  - NOT turnover
- But tactically why?
  - Forced or voluntary
  - New markets, skills, clients
  - Bench strength
  - Cost base
  - Risk
  - Succession / exit
  - The availability of finance



Value

- What does 2 + 2 make?
  - Are you a buyer or a seller – depends on perspective – few real mergers
  - Determines negotiating position
  - Manage expectations between partners
- Methodologies
  - Net assets (at buyer's valuation!!)
  - Earnings
  - Others are probably unreliable
    - Multiple of fee income
    - Yield
    - DCF
- Business model implications
  - Process driven may have goodwill
  - Collegiate type practice – unlikely to



Net assets

- By far the easiest
- Adjust for values of underlying assets – balance sheet only a starting point
- Other liabilities e.g. PII run off (typically 3 x annual premium), redundancy, close down costs
- WIP subject to CFA often not included
- CFA WIP
  - Usually called goodwill as on sale likely to be taxed at 10%
  - Time records usually unreliable
  - Eliminate “dead” cases
  - Number of cases X average value achieved % 50% (to through)
  - Apply a discount (see later on market conditions)
  - Role of specialist valuers



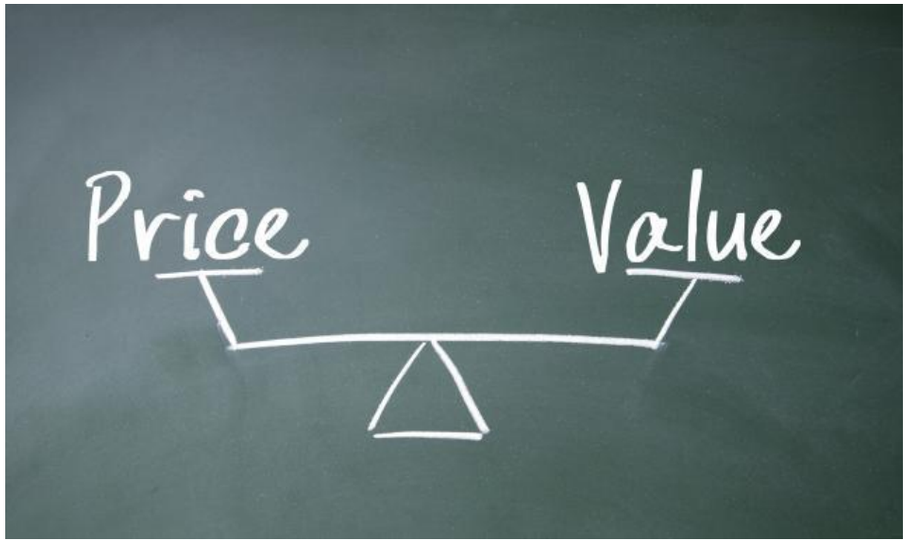
Earnings basis

- Goodwill = sale value less net assets
  - Not as much as you may think or hope
  - Unlikely in collegiate practice – possibly in process driven firm
- Higher of net assets basis or earnings basis
- Maintainable recurring profits X multiplier
- Variables
  - Definition of maintainable – exceptional costs and income
  - A weighting?
  - Partner reward as a deduction
  - What multiplier? – perhaps varies by dept.



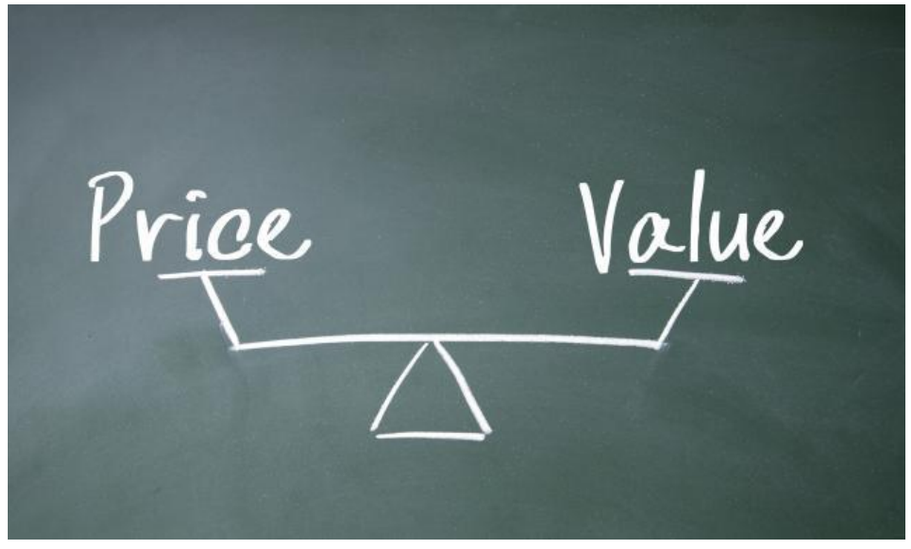
Achieving best price

- Price is only one element but is it a merger or sale?
- Use a lead adviser
  - Indicative “price” & structure
  - Independence
  - Confidential approaches
  - Market knowledge
  - Play “hard ball”
- The process
  - Create a competitive market
  - Prepare Information Memorandum
  - Identify targets – limited number – blanket approach dangerous
  - The process
- Six to nine months timescale



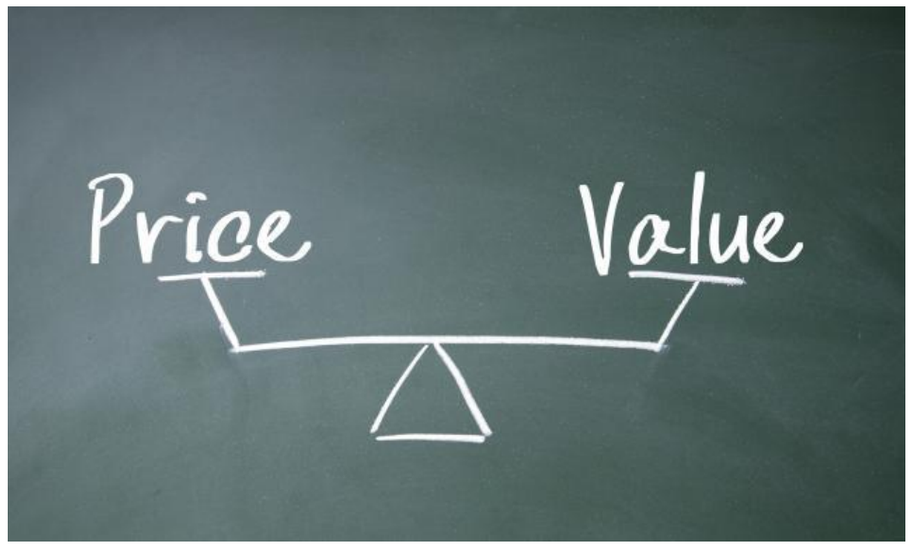
The process

- Stage 1 to indicative offers
  - Initial personal approach
  - Taster
  - NDA
  - Issue numbered IM
  - Meet targets – two way exchange
  - Indicative offers
- Tax issues – ER, company or asset sale, goodwill
- Stage 2 to formal agreement
  - Assess offers
  - Clarify & negotiate
  - Preferred party – exclusivity
  - DD and final negotiation
  - Signed agreement



Other issues

- The people and the culture
- Process of finding a firm to acquire
- Post deal integration a vital element to avoid being one of the 50% deemed to be a failure
- Deal breakers
  - Name & car policy
  - ‘Who gets what?’
  - Profit shares /money
  - Liabilities
  - IT incompatibility
  - Who goes & what gets closed
  - How the business will be managed
  - Unusual structures or practices
  - Acquirer's solvency!!





Financial strategy for law firms