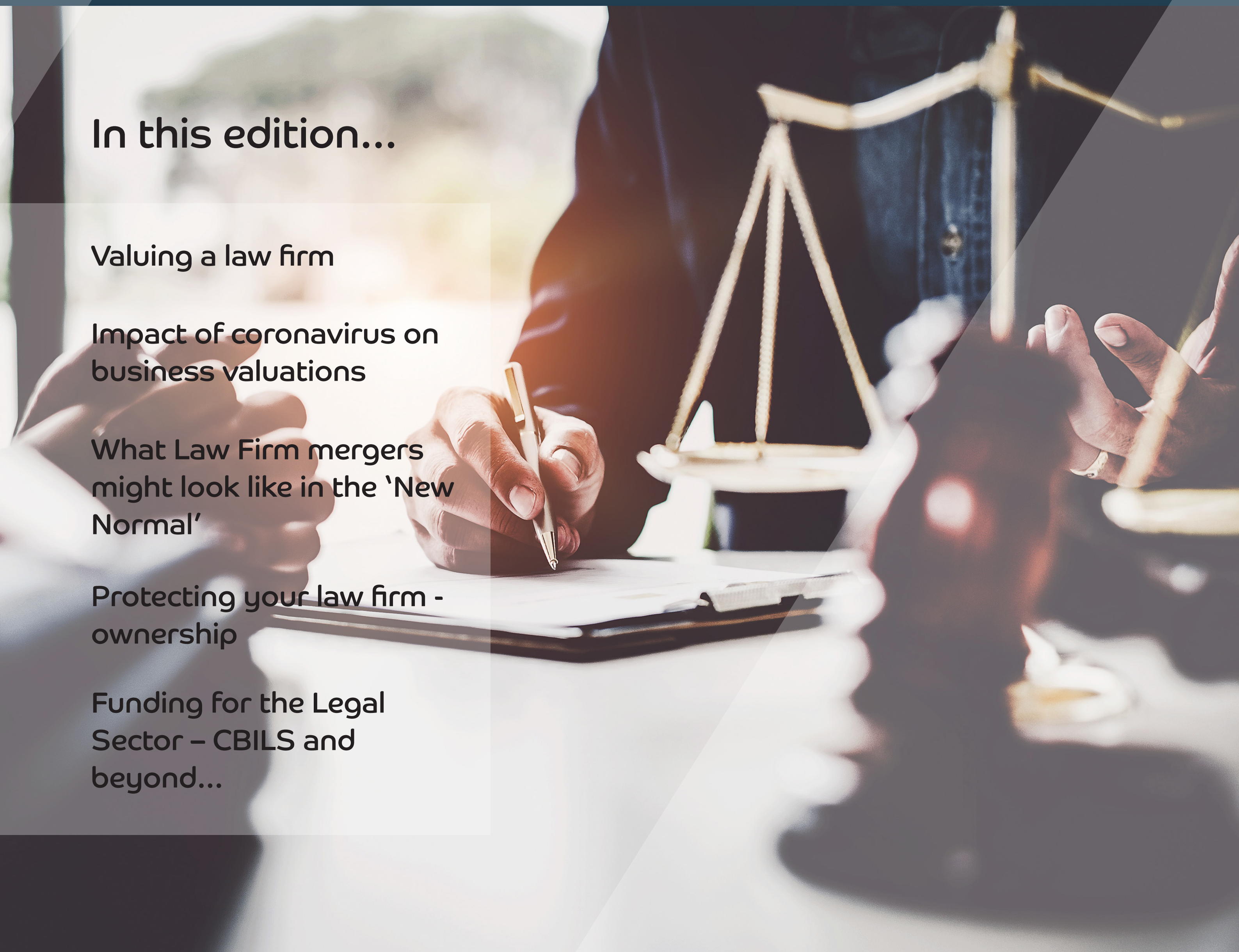
the law

Autumn 2020

Working with The Law Society

Armstrong Watson's specialist publication for the legal profession



In this edition...

Plus an interview with...

Andy Poole interviews John Clarke, Head of Sales at Wesleyan Bank, specialist providers of finance to the legal profession

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A track record of providing solutions to the legal profession

In this edition...

Exclusively working in partnership with the Law Society for the provision of the following services to law firms.

Working with
The Law Society

- Strategy Planning Workshops
- Business Plans
- Benchmarking
- Mergers & Acquisitions of Law Firms
- Law Firm Valuations
- Forecasts
- Raising Finance
- Lock-up Reviews
- Pro-active Tax Planning
- Tax Compliance
- Audits
- Accounts Rules Reporting
- Accounts Preparation
- LLP conversions
- Incorporations
- ABS Applications

Welcome

Welcome to the Autumn 2020 edition of The LAW, the specialist publication for the legal profession from the legal sector team at Armstrong Watson.

As many of you will know, we host over 60 events for lawyers every year and despite Covid-19 we are continuing to hold them via Teams so that we can still pro-actively help to improve the business of law - which may be needed more than ever in the coming months. I would encourage you to continue to attend the events. I hope you are all keeping well and that your firms are too.

We focus on funding and valuations in this edition, two topics that are very appropriate right now, with articles including:

- How to value a law firm
- Valuations of businesses for matrimonial or dispute purposes
- An overview of the legal M&A market
- Protection for law firm owners
- Thoughts on funding for law firms from Armstrong Watson's head of funding
- An interview with Wesleyan on funding options

Specialists are available from all of our 17 offices, to provide pro-active support and advice to lawyers in compliance and business improvement matters. This publication is designed to allow us to share our collective experience in acting for lawyers throughout the UK.

To find out more on any of the above, including how we can work with you to help you and your clients, please do get in touch with me.

Andy Poole

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Valuing a law firm – external transactions and internal succession

What is my law firm worth? This is probably the question that the legal sector team at Armstrong Watson is asked the most. Interestingly, the question can be asked for a number of different reasons including in relation to a merger/acquisition; changing the structure of a firm; partnership (or ownership) disputes; and finally if a firm is looking at succession.

So, what is the answer? Well, it depends and it is not an exact science. The actual value will only ever be determined through negotiation between a willing buyer and seller, but in the absence of this, valuations tend to be done using one of the following three methods:

1. Applying a multiple to maintainable fee income.
2. Applying a multiple to maintainable net profits or earnings.
3. Valuing the net recoverable assets of the practice and determining if there is any goodwill.

The valuation tends to be no lower than the net assets of the practice. It should be noted, however, that if the practice ceased trading, the recoverable assets would likely be lower than the net asset value per the accounts as some assets would be worth less than their book values (equipment, library etc) and not all WIP and debtors maybe fully recovered. There would also be additional costs such as professional fees, run off cover and redundancy costs associated with any closure.

As mentioned above, there are a number of reasons for valuing a law firm, and each reason is likely to produce a different valuation, in the main driven by the objectives and bargaining powers of the purchasers and sellers of the firm.

Valuations that we are currently seeing in mergers and acquisitions

In the law firm mergers and acquisition market, now more than ever, we are seeing deals (and valuations) based on the net assets approach rather than the multiples approach, as many law firms do not have any inherent goodwill within them. This is particularly the case with small, traditional, high street practices (recent figures show that 87% of all practices in the UK are either sole practitioners or firms with four or fewer partner) and with an ageing partner population, an acquirer is unlikely to pay for any goodwill as many of these firms have real succession issues and no other viable options.

However, some firms do have goodwill within them, and those firms tend to achieve values based upon profit or fee income multiples. Those firms tend to be boutique firms specialising in niche or growing areas of law and are sought after by acquirers including private equity backed firms and consolidators, hence the higher values. In these cases multiples in the range of 4-5 can be achieved, and even higher for corporate firms selling to the newly listed acquiring entities, although 3-4 is probably more common in practice.

Valuations on internal succession

There is no doubt that there is a real succession issue for many law firms within the legal market in the UK, and so the key driver for many existing partners is to be able to exit without having to pay PII run off cover and recover their capital rather than to have a good will payday on exit or to admit a new partner. It is therefore far less likely for a multiples based approach to be taken for internal succession purposes.

That being said, it shouldn't automatically be assumed that a payment for goodwill is not achievable. Some firms with above average profits may still expect goodwill to be paid when a new partner comes into the business. We do see goodwill being paid in some circumstances, and the partnership or members' agreement will tend to govern how this goodwill is valued. When owners pay goodwill on entry, they tend to also look for goodwill to be paid to them on exit.

Succession planning is something that law firms should consider from (ideally) the very outset, and be regularly reviewing. It is not something that should be first considered just before exit or retirement, as that is likely to provide fewer options and impact on the valuation of your firm.

Funding

In the majority of the above situations, albeit at varying levels, there is likely to be a requirement for payment of some sort, and therefore funding is likely to be required.
It is important to understand the different funding and types of payment that may be required.

Capital contribution

Contributing capital to a practice is different to a payment for acquiring a share of a practice. A capital contribution is essentially a loan to the practice and would form part of your capital or current account (or director's loan account in a company) and would be repayable to you on exit. A capital contribution will be required by the majority of partners in a law firm.

Some practices allow capital to be input or built up over time, but most require this to be paid on entry. Many new partners obtain a partnership capital loan to facilitate this payment. These loans are common and are offered by high street banks as well as specialist legal sector funders.

There are equivalent loans available for investing capital in a limited company but these are not as common.

Tax relief is available on the interest paid on these loans and therefore should be considered over making capital contributions out of personal funds (if the individual also has a mortgage for example).

Funding for equity buy outs and mergers or acquisitions

In a number of the above scenarios, funding for payments in excess of capital will be required which is a separate lending product. Although your bank is always a viable option for funding, many bank managers (unless they specialise in professional practices) may not have the detailed knowledge of the intricacies of law firms (WIP cycles, off balance sheet WIP etc) to facilitate more than a moderate level of funding and in these circumstances, a specialist funder maybe a further option.

Armstrong Watson has a wealth of expertise in securing funding for our clients, whatever the circumstances, and work regularly with a network of lenders. Our team is ideally placed to assist you with talking you through your funding options and negotiating with lenders to obtain the most appropriate and commercial terms on your behalf.

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Impact of coronavirus on business valuations

Business valuations are required for a large variety of legal cases, including family matters, disputes and transactions. Matthew Geale, Partner and Head of the Armstrong Watson dedicated Forensic Accounting team investigates the impact of COVID-19 on the valuations that we undertake on behalf of lawyers.

The recent COVID-19 health pandemic is having widespread effects on many areas of people's lives around the world. In addition to the health risks, many people are facing uncertain times from a financial perspective. In this article, we look at how business valuations may be affected in the current environment and provide examples of topics you may wish to discuss with your clients.

Trading

With lockdowns enforced around the globe, many businesses were forced to close the doors to their trading location. For some, this meant no revenue. For others, it resulted in income from a different stream. Some businesses have been trading online, some have adapted their product/service for collection or delivery only. Very simply, the value of a business is the present value of its future profits/cash flows and many valuations assume that historical data can be used as an indication of future trading performance. When considering the value of a business now, whilst historical data may still be taken into account, there are a number of additional points you may wish to discuss with your clients in order to understand what position the business is currently in and what they anticipate may happen.

Current position

- Has the business traded during the pandemic/lockdown?
- If so, by what means?
- What levels of revenue have been generated?
- How does this compare with what was forecast?

Anticipated position

If one thing has become apparent, nothing is certain in the present climate. With many unknowns going forward, it may be helpful for you to consider matters such as:

- What does future trading look like?
- Has the entity's business model changed?
- What challenges does the business face and what plans have they put in place to address these?
- Have there been other operational adjustments such as changes in staff levels, furloughing of staff etc.?
- What does their cash flow position look like and do they still have the support of their bank?

In assessing such information, it is important to consider whether any effects are permanent or just short term. Whilst clarity is a pipe dream for many at the minute, it may be that, with some thought and careful consideration, the future can be estimated with some degree of accuracy. What the outlook might be will depend on how permanent the effects of coronavirus will be. The answer to this may require detailed discussions and a thorough review with your clients.

Value of the business

Whilst you and your client may have an understanding of what the value of their business is likely to be, the current situation may result in additional areas for you to consider that could affect the value. Below are some examples of matters that you may find helpful when assisting your clients:

- What is the purpose of the valuation?
- Will there be a monetary transaction that follows?
- If so, has the funding of such been affected by COVID-19?
- Are prospective buyers likely to have changed their attitude to risk in recent times?
- Is there a divergence between fair value and market value?

Summary

When considering business valuations, one of the main impacts of coronavirus has been uncertainty and this has resulted in more things to think about when valuing a business. The value of your client's livelihood and, often, lifelong work, may have been altered in the last few months, but it may not be permanent and it may even lead to improvement and efficiencies that increase long term value. With careful planning and consideration the correct approach can be taken and an appropriate value assessed.

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What Law Firm mergers might look like in the 'New Normal'

Armstrong Watson was delighted to host a webinar on the above topic recently including our Guests Andrew Roberts (Chairman, Association of Law Firm Merger Advisers) and Mark Briegal (M&A lawyer, Bennet Briegal).

Key themes from the webinar:

Are mergers happening right now?

The panel ultimately took the view that they were. However, there was clearly an initial slow down/pause as many firms had to deal with the immediate impact of lockdowns, home working etc. As everyone (law firms included) calibrated to a new normal, the M&A activity went back to (approximately) two thirds of previous levels with the remainder paused rather than scrapped.

Does that mean they are all distressed sales?

There was broad agreement amongst our panellists that there is likely to be an increase in distressed sales, but that it had not happened yet. It was also noted that various deferred consideration modals have been used for some time, but they will likely become increasingly common.

So is it a buyers market post Covid?

Our speakers noted that buyers will probably be a bit more cautious and more likely to use deferred considerations but that does not necessarily translate to a buyers market. There are still very good firms that will look to consolidate, and there will still be private equity and listed firms driving from the top end.

But surely not a sellers market?

As Andrew Roberts noted, it is important to decide if you are "prey or predator" but that it is ok to be either and there will be perfectly valid strategic reasons to seek another larger firm to acquire yours. That said, if you do want to build scale and have complimentary services now is the time to get in before there is a "rush" of sellers making it more difficult for buyers to see that distinction.

So does all this mean there will be more consolidation in the market?

Mark Briegal summed up this area of the discussion neatly – it "depends". The panel acknowledged that consolidation in the legal market is due, and that perhaps Covid will be the catalyst for that. However the recession of 2008 caused nearly as many boutique firms to open as it did larger firms to fail – so there is a possibility we will see the same again.

In talking about what firms should do now there was consideration of how to make your firm either attractive to potential acquirers/merger partners or prepare yourself for potential approaches. It's clear that whichever side of that coin you find yourself on, firms can be taking steps now to prepare for some movement in the M&A market over the next 6-18 months.

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Read our views of the impact of Covid-19 on law firms at:

https://www.armstrongwatson.co.uk/services/covid-19-and-your-business/impact-covid-19-legal-sector

Protecting your law firm - ownership

Recent research undertaken by Armstrong Watson in 2018 has revealed that the average number of owners of a business is 2.5. For law firms that figure is higher than for traditional businesses of an equivalent size, and the ownership also tends to change more regularly in law firms. In the past 10 years there has been a tendency for firms to convert away from Partnerships to LLPs, and more recently and now more commonly to Limited Companies according to research from the Solicitors Regulation Authority (SRA).

A larger number of owners means there is an even greater chance of the ownership changing, whether planned or not, but frequently there isn't a formal succession plan in place to ensure how this would happen. If there is nothing in writing stipulating exactly what is to occur on a change of ownership, then this could be a challenge for those left running the business, particularly in the event of an unplanned exit such as death or serious illness.

For a limited company, what happens in such scenarios could be detailed in the Articles of Association and for Partnerships and LLPs, in a partners/members agreement. Many haven't reviewed such documents since they were first created; it is important to do so to ensure that what you want to happen on exit/death can actually be put in place.

If no formal arrangement is in place then if death of an owner was to occur, shares/interests in the law firm would ordinarily go to spouses/dependants via a will. However, the remaining owners are unlikely to be happy with that as in traditional firms they tend to prefer to continue to run the firm as a group of lawyers with management and ownership combined; the pros and cons of which are a whole separate topic. The SRA would also not allow it unless the firm converts to an Alternative Business Structure (ABS), although they usually allow a short grace period.

Assuming the intention is for the remaining business owners to take over the shares, a formal agreement needs to be put in place. Arrangements should be documented as to how the shares are to be paid for and how the family is remunerated.

A simple solution is for each owner to take out an insurance policy for the (fair) value of the shares, the proceeds of which could be used to purchase them from the deceased. Each policy would require an accompanying cross option agreement, ensuring that the sale of the shares/ownership is legally accommodated.

A claim on a policy would result in the sum assured being paid out to the law firm, who now have the funds available to purchase the shares/ownership from the deceased's estate, putting the money in the hands of the family and the shares/ownership in the hands of the remaining business owners.

This is a simple and effective way of covering the liability should death (or serious illness) occur. Our independent financial advisers can help you review both your business and personal needs and help you prioritise what's important to you, your business and your family.

Protection policies will usually require medical underwriting and the premiums could be affected if the individual being insured has any existing health issues. When taking out a protection policy it is important to disclose all pertinent information and providing false details or insufficient information at the outset could be detrimental to a future claim.

- Does your firm have a formal agreement in place?
- Do you know the value of your firm? There can be significant value at stake here, even if only balance sheet/capital accounts based value rather than goodwill value of the business
- Do you have the funds in place to facilitate the purchase shares/interests?

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Valuing law firms is covered in a separate article in this edition of The LAW and further details on how Armstrong Watson can undertake the valuation can be found at:

https://www.armstrongwatson.co.uk/sectors/legal-sector/law-firm-valuation

Funding for the Legal Sector – CBILS and beyond...

The stats for the various government backed funding schemes – Bounce Back Loan Scheme (BBLS), Coronavirus Business Interruption Loan Scheme (CBILS), Coronavirus Large Business Interruption Loan Scheme (CLBILS) and Future Fund (FF) – as of the 4th August 2020 show that there have been over 1.5 million applications from businesses, with over £50bn worth of applications approved to provide much needed support to businesses as a result of the Coronavirus pandemic.

Whilst these schemes have been welcomed by the business community only time will tell whether these have been sufficient in enabling businesses to survive in the long run, rather than just during shut down.

One challenge faced by the legal sector when looking for financial support has been accurately forecasting the level of support which will be required. This is in part due to the general uncertainty around timescales for returning to normal, but also due to the time cases take to make their way through WIP and completion.

Whilst the lockdown period allowed law firms to focus on working the existing caseload, new work has not been as forthcoming, meaning that WIP reductions may mean there is a cash shortfall in Autumn 2020, as PII becomes due for many law firms, through to Spring 2021 as tax and other deferrals need to be paid.

There are many unanswered questions around the level of support for businesses post-Covid. The upcoming pressure on working capital from the various measures undertaken by businesses to get through the lockdown period (such as VAT deferrals, CBILS, capital repayment holidays, rent deferrals etc.) will in turn put increased pressure on banks and lenders as further demand for working capital is experienced.

As CBILS and the various government backed schemes come to an end, options for obtaining funding will revert to more traditional products. It is yet to be seen how supportive lenders will be now that the government guarantee has been removed and businesses have potentially suffered financially due to lockdown.

This is where engaging with a Corporate Finance professional is paramount as they will be aware of the appetite for lending within the marketplace and who would be best suited to assist the business with its funding needs.

Alongside day to day funding, you may look for funding for any potential mergers or acquisitions that you may wish to undertake. There will no doubt be opportunities created by the economic climate in 2020 for acquisitive firms to expand. Lenders are always keen to support these types of transactions and there are an increasing number of options for acquisition funding within the market, regardless of size and deal structure.

As part of any transaction most lenders would expect a Corporate Finance advisor to be engaged to undertake things such as valuations, negotiations, financial due diligence and deal structuring on behalf of the acquiring business. This will provide lenders with comfort and confidence that best advice is being taken and a deal agreed which suits all parties.

Key to any lending request is a robust and detailed application and realistic set of financial forecasts to demonstrate the requirement and the financial performance of the business moving forwards, highlighting the affordability to repay any borrowing and benefits of any investment to the business.

Again utilising your trusted advisor network to ensure that you have the most appropriate structure and level of funding in place to support the business now and in the future is key.

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An interview with...

Andy Poole interviews John Clarke, Head of Sales at Wesleyan Bank, specialist providers of finance to the legal profession

Funding is a hot topic in the legal sector right now given the risks that COVID-19 has presented to law firms and so Andy Poole interviews John Clarke on his current experience in the sector.

Just like Armstrong Watson, Wesleyan Bank has a formal relationship, working in partnership with the Law Society. Tell me a little about that partnership.

Wesleyan Bank has had a longstanding relationship with the Law Society that spans the last 12 years. It covers all aspects of short, medium and long term commercial funding. For example, we are the only provider of practising certificate finance at source i.e. on the SRA website. Our partnership also includes VAT, tax, professional indemnity insurance (PII) funding, asset-related investments including technology finance such as software implementation, partner equity loans and commercial mortgages.

In recent years, Wesleyan Financial Services has also joined the relationship to provide personal financial services to the legal community with a focus on financial education and helping lawyers plan for their future.

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In your experience, how have the finances of law firms been impacted by Covid-19?

Whilst some segments of law have not been impacted or sadly seen growth such as family law, wills and probate, others such as conveyancing have been heavily hit in the short term due to restrictions around viewing and property sales. Finances, both personally and professionally, have been affected across the board. The UK legal sector generated revenues of £9.34bn in the first quarter of 2020, down 6.6% on the last quarter of 2019, and firms are forecasting a 10-20% fall in revenue for the 2020/21 financial year. Firms that were struggling prior to lockdown are now seeking to access larger lines of credit at a time when many principle banks are withdrawing products and focussing on existing customer lending.

Even where there is an appetite for new customer finance, the introduction of the Government backed CBILS and BBLS schemes have been an equal blessing and a curse as some lenders are focussing on these exclusively. As a result, some have withdrawn other products from sale and are struggling to cope with the influx of enquiries that these have brought, leaving firms waiting longer than normal for decisions and with a reduced range of choices for their finance needs.

Despite the pinpoints of light, such as the tax and VAT deferral, these have also posed a dilemma. Do firms take advantage of these now, knowing they may store up larger bills in January when their credit position may have deteriorated further, or do they pay them today and look to spread the costs as far as they can? With the end of furlough, there are also difficult conversations to be had about continued home and reduced hour working and in some cases how to fund the investment in technology that this needs.

How and when will the finance requirements of law firms change going forward from here?

The second half of the year will be crucial for many firms as they renew both their Professional Indemnity Insurance (PII) and their practising certificates, two non-negotiable elements they need in order to trade. The PII market has undergone a vast change over the last three years and there are now fewer insurers, which has led to a focus on customer retention and sadly a hike in premiums, potentially upwards of 20%.

PII applications take a lot of time and effort. For those wanting to shop around, my recommendation would be start early and, in light of recent insurance pay out track history, be very clear what is and isn't covered by your provider and the risks any gaps in cover may give you. Both of these items can be paid over time and we have recently launched an initiative with the Law Society offering fee free PII loans that have an initial first month deferral. It's also worth noting that some insurers will give lower premiums for effectively block buying - if you are part of a multi-site firm practice – it may be worth investigating this option.

On the flip side, cash into the business should also be a focus. There is greater emphasis on identifying customers that may struggle to pay their legal fees if they are experiencing financial difficulties. As such, law firms may want to review their processes about handling these cases and be clear as to when and how payments are due to prevent the client running into problems.

What funding support is available for law firms right now?

It really isn't all doom and gloom. Firstly, there are a wide range of government backed schemes aimed at kickstarting the economy and retaining jobs, from CBILS to BBLS to the £1000 grant for staff retention and deferment of key payments like VAT and tax. In addition, tax break incentives that were on offer prior to COVID-19, like the Annual Investment Allowance, are still in place.

Many of the day-to-day business management things you do will be especially relevant now. These should extend to maintaining accuracy of billing of hours, proactive supplier and contract negotiation, collaborative purchasing and prudent cash management and collection. Helping with that, there are a number of free to access advisory services such as the Law Society itself and a wide network of experienced professionals, such as Armstrong Watson.

Finally, it would be remiss of me not to mention alternative finance providers like Wesleyan Bank who may be able to help with either services or terms not available via your business Bank.

What steps would you suggest law firms take to put their finances on a stronger footing and to put themselves in a better position to be able to access finance, if needed?

We recently produced a return to work guide that covers everything from revaluating your business plan, through to creating a safe working environment and reviewing the finances of your organisation. The guide references a number of sources of help that are available to you, but we aren't the only ones and the Law Society has a whole section of advice and support for those that are heading towards financial difficulty. The pandemic has brought out more compassionate levels of understanding in many, both in a personal and professional context, and should you find yourself in difficulty make early and proactive attempts to seek help.

Also, don't leave it until you are in need of finance to start your search. Speculatively access the professional network that you have worked so hard to establish. Your accountant and many of the alternative financial providers will be happy to talk to you at this time, irrespective of whether it results in business for them or a referral to a different resource.

To request a copy of Wesleyan Bank's back to work guide, or if you would like to discuss any of the topics raised in this article, please contact John Clarke for more information – john.clarke@wesleyan.co.uk | Tel: 01606 338009.

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