

Moving forward with mergers

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Moving forward with mergers

- Why mergers are back on the agenda
- How mergers can help to achieve strategic objectives
- The merger process
- The seller's perspective
 - Grooming the business
 - Appropriate structures
- The buyer's perspective
- Due diligence
- Goodwill and the value of law firms
- Other options and exit routes



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Why mergers are back on the agenda

- Retirement/succession
- Legal Services Act
- Legal aid reform
- Personal injury reform
- Difficult trading conditions
- Regulatory reform



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How mergers can help to achieve strategic objectives

- A merger is not a strategy in itself
- Protect legal aid income
- Enlarge the range of services
- Move into new geographical markets
- Protect personal injury income
- Build a brand



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The Merger Process (1)

- Starting point – look at your own firm
 - SWOT analysis
- Strengths/Weaknesses
- Opportunities/Threats
- Staff Contributions
- Benchmarking information
 - Armstrong Watson Survey
 - LMS Survey



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Armstrong Watson Benchmarking

- Less than six partners
 - Net profit per equity partner £78,345
 - Fee income per equity partner £244,500
- Six or more partners
 - Net profit per equity partner £123,563
 - Fee income per equity partner £438,151
- Detailed benchmarking review available



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The Merger Process (2)

- Starting point – look at your own firm (continued)
- Identify key objectives – partners as individuals and firm as a whole
- Business planning – e.g. working capital requirements
- Client needs – how this may change
- Staff and resources review



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The Merger Process (3)

- If the partners' objectives cannot be met by other means then the merger/acquisition should be explored
- External review
 - What are the key features required, scale, location, client base, work types?
 - Identify firms meeting these criteria
 - What are your competitors doing in this marketplace?
 - Plan vision for the future practice – work out what you want to buy/sell and the post merger vision
- Start the process – draw up a shortlist of firms to approach and agree it among partners



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The Merger Process (4)

- Make the approach
- Confidentiality agreements
- Identify the deal breakers and Heads of Terms
- Due diligence
- Deal evaluation
 - Consider results of due diligence
 - Review against key objectives
 - Discuss with key stakeholders
- Post merger business planning



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The Seller's Perspective (1)

- Grooming the business
- Same issues whether wanting a complete sale, a merger or to attract external investment
- Make the business attractive
- Get your house in order – don't get caught in a fire sale
- Accounting records/management systems
- Old debt/WIP
- Taxation compliance
- Accounting policies
- Business plans
- Projections
- Operational matters
- Management



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The Seller's Perspective (2)

- Grooming the business (continued)
- Timing – income profiles and profit trends
- Strong profit track record coupled with demonstrable future growth
- Build market share and critical mass
- Not dependent on partners
- Leverage
- Systems and IT



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The Seller's Perspective (3)

- Grooming the business (continued)
- Structure
 - Partnership?
 - LLP?
 - Limited Company?
 - Who selling to?
 - Separate parts of business into different entities?
 - Hybrid structures?



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The Buyer's Perspective – due diligence

- Areas of operations to review will include:
 - Fees
 - Other financial information
 - Risk
 - Staff
 - IT systems
 - Governance



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Due Diligence (1)

- Fees
 - Client base
 - Average fees per client
 - Average fees per partner
 - Average fees per fee earner
 - Trends and projections
 - Departments



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Due Diligence (2)

- Other financial information
 - Analysis of historic results
 - Analysis of projected future results
 - Profitability by department
 - Profitability by partner
 - Accounting policies
 - Net assets
 - WIP
 - Valuation method
 - Recoverability
 - Success rates



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Due Diligence (3)

- Other financial information (continued)
 - Contingencies and commitments
 - Partner annuities, loans and capital/current accounts



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Due Diligence (4)

- Risk
 - Work types
 - Quality control procedures
 - SRA visits
 - SAR reports
 - Claims history
 - PII Insurance premium



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Due Diligence (5)

- Staff
 - Numbers
 - Departments
 - Ratios
 - Structure
 - Salary rates
 - Qualifications
 - Status
 - Training



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Due Diligence (6)

- IT systems
 - Information
 - Compatibility
- Governance
 - Partnership agreement



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The Merger Process (5)

- Business planning will be essential and cover the following areas:
 - Objectives
 - Work types and geographical markets
 - Marketing the new practice
 - New practice trading structure
 - Governance arrangements, managing partner/management team/chief executive/department heads
 - How to retain “old” arrangements for partner retirements, dealing with inconsistencies between the firms
 - Succession planning and incoming partners



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The Merger Process (6)

- Business planning will be essential and cover the following areas: (continued)
 - Financial modelling to demonstrate key areas of the merged practice, cashflow requirements and partner profit share arrangements
 - Property arrangements, in case of merger to quickly establish to the outside world “one firm”



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Taxation Issues

- Compliance – transfer of VAT and PAYE
- Merger – continuation of business and no overlap relief
Acquisition/Sale – cessation of retiring partners and overlap relief claimed
- Different status for different partners
- CGT issues with disposal of goodwill
- Opportunities to consider
 - Trading as a company/hybrid



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Options

- Larger practice taking on small practice
 - consolidators?
- Merger of two similar sized practices
- External investment/ownership



Merger or Acquisition?



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Merger

- Rare to see a pure merger in control terms but ...
 - No payments
 - No goodwill
 - Work in progress and debtors paid as collected
 - Agree profit sharing ratios
 - Accounting policies and merger accounts are key



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Acquisition

- Acquiring a practice (or share) at an agreed value
- Paid for in cash
- Paid for in shares?
- Potential deferred payment
 - Retention of clients?
- Valuation based on profitability or fee ratio
- Pay for net assets plus uplift for goodwill
- Pure valuation of practice



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Goodwill and the value of law firms

- Value of any investment is the sum of future economic benefits at today's value
- Professional service firms – focus on goodwill
- Is there goodwill in the legal sector?
- Subjectivity
- Valuation: use of multiples is common



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Practice Valuations – Issues (1)

- Roles of partners in post merger firm
- Work types
- Projections – maintainable earnings
- Property
- WIP valuations



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Practice Valuations – Issues (2)

- Value multiples
 - Client base
 - Staff
 - Systems
 - Services
 - Position/brand
 - Scale
- But – already reflected in profit?



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Practice Valuations – Issues (3)

- Value to acquiring practice
 - Synergies
 - Spare capacity in fee earners and support staff
 - Integration costs e.g. redundancies/lease breaks
 - Partner retirements



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Cultural Issues (1)

- A definition of culture:

“A set of beliefs, values and assumptions that are shared within a group”

“the way we do things around here”



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Cultural Issues (2)

- A cultural mismatch is just as dangerous as a strategic mismatch....
- Never analysed in as much depth
- Understanding your own culture is a major step to identifying the potential for cultural compatibility



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Cultural Issues (3)

- Culture is learned over time
- New people join and become absorbed into this culture
- Putting two firms together is likely to lead to at least some incompatibility
- How realistic is it to talk of creating a “new culture” post merger?



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Cultural Issues (4)

- Examine the culture in both organisations
- Don't assume that similarity in systems means cultural similarity
- Think of cultural adaptation rather than cultural change
- Think about blending cultural elements from each firm



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Cultural Harmony

- Explore the attitude and behaviour of the people
- Culture is often ignored – tight timetables
- Use outside help
- Identify at least some cultural harmony at the outset



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Culture Post Merger

- Accept that deep seated cultural beliefs will never change in the short term
- Focus on the positive aspects of the combined firm's culture
- Don't trumpet "new values"
 - Implied the old ones lacked merit



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Regulatory and risk perspective

- Financial due diligence
- Projections
- Taxation
- Legal due diligence
- Quality marks
- Supervision procedures
- Merging the teams
- Changing processes
- Claims records/PII premiums
- Registering with/approval from the SRA



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Other options and exit routes (1)

Exit routes

- Barriers to exit
 - Large capital accounts
 - No identified succession
 - No interested succession
 - PII run off cover/successor practice issues
 - Regulatory issues
- Orderly closure



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Other options and exit routes (2)

Continuation

- Niche focus
- File sales (rather than fire sale)
- Alliances
 - Connect2Law
- Joint ventures – ABS
 - Hub and spoke
- Succession – identifying talent and locking them in
 - Share incentive schemes?
 - Early involvement in the business



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How Armstrong Watson can help

- General support, advice and management of the process
- Finding targets
- Brokering the deal
- Practice valuations
- Due diligence
- Merger checklists
- Trading structure reviews and conversions
- Tax planning to realise goodwill
- Incentive schemes to help succession



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Summary

- Legal services market changes driving merger activity
- Identify strategic goals
- Does merger fit with strategy?
- Planning the process
- The sellers perspective
- Grooming the business
- Appropriate structure
- The buyers perspective
- Due diligence
- Practice valuations
- Cultural issues
- Regulatory and risk perspective
- Other options and exit routes



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