WHY MIGHT LAW FIRMS CONSIDER A MERGER?

**Survival, sustainability, thriving**

The fundamental objective of any organisation is to survive, and beyond that, to be sustainable and above that to thrive. That may be surviving and thriving in the short term to an exit or over the medium or long term as an ongoing entity.

Survival is dependent on not running out of money and becoming insolvent. The next step beyond that is being sustainable- having enough clients, employees and money to keep going. “Thriving” might be defined by achieving, or exceeding, whatever objectives the organisation has set itself, and achieving its Mission and Vision.

To survive, be sustainable, and to thrive, requires

* Sufficient, profitable, ongoing demand from clients;
* the ability to profitably deliver the firm’s chosen legal services in compliance with all the appropriate regulation;
* the attraction and retention of sufficient and appropriate staff to deliver these services and to support the organisation; and
* sufficient capital to fund the operation’s working capital and investment needs.

**Competitive pressures**

The ability of individual law firms to survive, be sustainable and to thrive in the future, as ever, will reflect ongoing competitive pressure for both clients and for employees, and increasingly the ability to invest in and effectively deploy technology and AI.

Competitive pressures reflect not just the short- term competitive environment but also emerge as a result of longer- term changes within the business environment. These can include globalisation or localisation, de-coupling of economies, economic growth, decline or stagnation, demographic changes, political changes, environmental changes, changes in legislation and regulation, social phenomena, and changes in the application, capabilities, use and costs of technology. These can all have implications on the size, shape and level of competitiveness within a market, and thus require a strategic response to sustain or develop competitive advantage.

**Merger to retain, sustain or obtain competitive advantage.**

Merger can be a strategic move to obtain, regain or sustain competitive advantage- in short part of a competitive strategy.

**To secure and sustain funding**

Law firms, like all organisations, require funding for their working capital requirements and for investment. In terms of the former, it is important to remember that organic growth will almost certainly lead to an increase in working capital requirements (“lock up”). The latter may include investment in lateral hires and new teams, into new ICT soft and hardware, into fit-out costs, maintenance projects and dilapidations for property, or into opening new offices.

Medium and longer term success will also reflect the ability of the firm to release capital to retiring partners and raise capital from new partners- or from other sources of capital.

Whilst a merger may require capital to be successfully implemented, it can also be a means of raising capital- either through increasing profitability which can be re-invested, persuading more people to become partners and invest, provide a better lending prospect for banks, or, in some cases to enable external equity investment.

**Merger to enter new markets to enable growth**

Merger can also be a strategic move to enter new markets- be that geographical or vertical (ie particular industries) to support growth or to backfill a decline in other markets.

**Merger as part of a portfolio strategy; diversification and growth**

Merger can also be a service diversification (as well as the above market diversification) strategy- again to increase growth prospects, to drive profitability by moving from lower profit markets and services to higher profit areas.

Service diversification, or, more often, strengthening service offerings, can be a strategic, or tactical, move to be able to offer more services, or, by strengthening weaker areas of service, equally strong services to existing clients. This will enable the value of existing clients to be grown, and/or to protect them from penetration by competing firms and their potential eventual loss to competitors.

**Economies of scale, scope and expertise.**

Another reason that could be a driver for a merger, and/or arrive as a consequence of such, is to obtain economies of scale. This can lead to the ability to afford and attract enhanced expertise and experience in key support functions such as Finance, HR, Business Development, and, of course, IT. This can support the realisation of competitive, growth and diversification strategies. It can also be part of a risk management strategy to diversify dependence on a small team and/or individuals within that team.

Economies of scale can also increase profitability, through spreading shared costs over a greater number of fee earners, to enable further investment in core business support areas such as

* IT & AI,
* Marketing
* HR

or to invest in more lateral hires.

If not re-invested, the benefits of economies of scale will be to increase profit per partner. This can enable partner capital to be released to those retiring, or rebuilt for existing partners, and/or to attract new partners to invest. Of course it can also be used to increase distributed profits- “drawings”.

Scale, or strength in depth in a niche firm, can also provide the firm with access to a greater talent pool of lawyers and support staff as it can provide greater career opportunities, greater earning potential, greater ability to afford to offer more flexible employment terms.

**Short term survival**

Having considered medium and long term strategic reasons to merge , another reason for a merger may be as stark as short term survival. It can be seeking a port in a storm or lashing two boats together to ride out a storm. Of course, tying two sinking stones together in a storm just makes them sink and perhaps faster!

**Current storms**

There are two current, hugely significant storms impacting the profession, and a third perhaps on the near horizon.

Firstly, COVID 19.

The impact that COVID has had on many organisations’ finances across the whole economy, and law firms are no different to this, is, in some cases, to materially reduce revenues. Despite government schemes to protect employment, this still results in a loss of margin (the difference between revenue and cost) with a consequent loss of profitability, which for some organisations has meant incurring significant losses, a consumption of cash reserves, and the need to borrow or call on equity providers for more capital to remain solvent.

Furthermore, re growth back to “normal”, as growth usually does, will require more capital to fund increases in working capital requirements- and capital reserves may have been consumed to address short term solvency issues.

A return to “normal” or design of a new “normal” way of working may also require capital to invest in “COVID proofing” offices or redesigning offices to reflect new working patterns. It may require additional capital to fund investment in enhance IT to better support new working patterns. It may require capital to exit leases and pay dilapidations.

The economic impact of COVID may also mean that a number of clients will no longer exist or will have a significantly reduced ability to pay for a law firm’s services, with some sectors such as retail, travel, entertainment and leisure, charities, commercial real estate etc, having been even more harshly impacted than others. This might have a medium to long term impact on the finances of some law firms or departments within such who specialise in these sectors.

Equally a bounce back and or demand for particular services such as insolvency & restructuring, employment law and real estate advice may drive significant short term growth- which needs to be financed from weakened balance sheets- as highlighted earlier.

The second potential storm, whose impact is perhaps not yet clear- and it may be a storm that throws up a lot of work (see point above about financing growth) or reduces a lot of growth, is the impact of BREXIT.

And the third potential storm is changes in the global geo-politic environment. A new President in the USA. A new German Chancellor later in 2021. There are significantly changing views within the political classes of the UK concerning interactions with China and Hong Kong. There will also be the ongoing global impact and aftermath of COVID.

Mergers may be a solution to the need to survive and thrive in these storms.

**Merger is a choice**

It is important to recognise, however, that a merger is a choice. Sometimes it is the best choice. Sometimes it is the least- worst choice. Usually, it is one of a number of choices (and indeed mergers with different firms will be part of the merger choice decision spectrum), and it is important to evaluate any merger in the light of such. Existing firms can only lose their autonomy once. Mergers can be costly, painful and divisive, and elements are outside of the firm’s control.

Organic growth, internal change programmes and fund raising for existing organisations can be faster, easier, and less costly, and may generate similar benefits. Any cost/benefit/risk analysis needs to consider the marginal differences between each option as well as absolute benefits.

Plenty of law firms, like most other types of organisations, have merged. Plenty have grown organically. Plenty have merged then grown organically. Some mergers have been very successful, some less so, and some have not worked out.

What is key is to do a thorough, professional evaluation of the choices, including the cost/benefits/risks and timescale of execution. Putting your head in the sand, gut feel and/or hoping for the best may not be the best approach. If you decide to do nothing- then do it explicitly having considered the options.

If you decide to merge, make sure you choose the right partner and make sure you execute the merger well and in a timely manner.