

How vulnerable is the UK legal sector?

The effects of the credit crunch and the high-profile failure of Halliwells have arguably exposed the underlying weakness of a business model that is based on the full distribution of profits each year. Recent analysis of the leading UK law firms* by Grant Thornton highlights that at a time when the business environment has deteriorated and clients are demanding more service for lower fees, further strain has been placed on firms' working capital positions. Most of the UK's leading law firms increased bank lending in the period from 2008 to 2009. The challenges in the current business environment mean that it may be more difficult for some firms to maintain existing lending facilities and as a result some may cease to operate in their current form.

Key sector developments impacting on performance

Pressure on fees resulting in lower profits - legal services are procured by sophisticated buyers that employ increasingly stringent methods to reduce legal fees. The use of law firm panels and e-auctions is now common place and their application has increased competitive tension in the sector putting further pressure on fee income and thus profitability eg legal panels that were composed of 10 law firms just two years ago are now being reduced to four or five to help drive down costs. Law firms with an exposure to product areas that are perceived as commoditised and those that are reliant on a small number of institutional clients are most at risk.

Increase in bank debt levels - between their 2008 and 2009 year ends, our sample of 44 leading UK law firms showed that they have increased their bank borrowings by an average of 38.4% whilst only increasing average members' capital by 10.3%. The combined bank debt of the firms in our sample stood at £636 million in mid 2009, up some £176 million on the prior year.

Our analysis shows that out of 44 firms only eight firms managed to decrease net borrowing in 2009 versus 2008. Cash resources were reduced significantly, in some cases due to firms taking the

opportunity to fund growth objectives but also impacted by a need to pay for partner exits and redundancy programmes over and above the 'normal' expenditure base. It is positive that many firms are investing in future growth but at a time when revenue and profits are heavily impacted by market forces this needs careful management.

Significant impact of comprehensive spending review cuts - pressure on fee rates is likely to intensify for those with a high exposure to the public sector, whilst government-funded workflow will be increasingly unpredictable. The anticipated cut of £350 million from the annual legal aid budget has been much publicised and is likely to impact on smaller firms. Legal budget cuts or freezes across all government departments are expected and onerous panel requirements for those working in the public sector are likely to add further costs.



The legal services act and the effects of deregulation - further deregulation of legal services will put an additional strain on the sector. Law firms with a reliance on commoditised work i.e. domestic conveyancing will find it hard to compete with new entrants that are supported by large scale operations offering services at a significant discount. In this price sensitive environment it is likely that cash strapped consumers will go beyond conveyancing when looking for 'budget legal advice'. Areas that are likely to suffer due to this competition include probate, some forms of dispute and even 'straight forward' divorce proceedings.

Low capital to debt ratio has limited appeal to investors - the low capital to debt ratio of some law firms will limit the businesses' attractiveness to third party investors once the Legal Services Act enables third party investment from October 2011. The debt position of some firms will need to be carefully managed if a 'White Knight' buyer or investor is to be found. Cherry-picking of talented individuals or teams is still perceived to be the preferred option for law firms to acquire talent from a competitor and these prospective lateral hires will also be keen to ensure that they are comfortable with the gearing of the prospective new firm. Also, valuing a law firm in distress can be a moving target due to partner departures and this can make divestments difficult to negotiate.

Lack of geographic diversification - some firms are suffering disproportionately because of their over-reliance on UK revenues. Though geographic diversification is by no means a guarantee for success, those firms that have the ability to source in-bound and out-bound work from jurisdictions including the US and BRIC countries are more likely to succeed in future than those that are failing to harness this valuable workflow.

Drive to remove the hourly fee model - some corporates including Tyco, Pfizer and Apple, to name a few, are pushing hard to agree retainer fees for legal work including for complex litigation and M&A advice. These arrangements, though yet far from being universally implemented, show a clear trend away

from the hourly fee model and towards stronger 'partnerships' between corporate client and law firm. This model is strictly limited to a small number of legal providers per client, and if implemented more widely, will not only drive down profits but also fundamentally change the way legal services are provided to the corporate sector.

Banks' strategies to deal with the changing risk profile in the legal sector

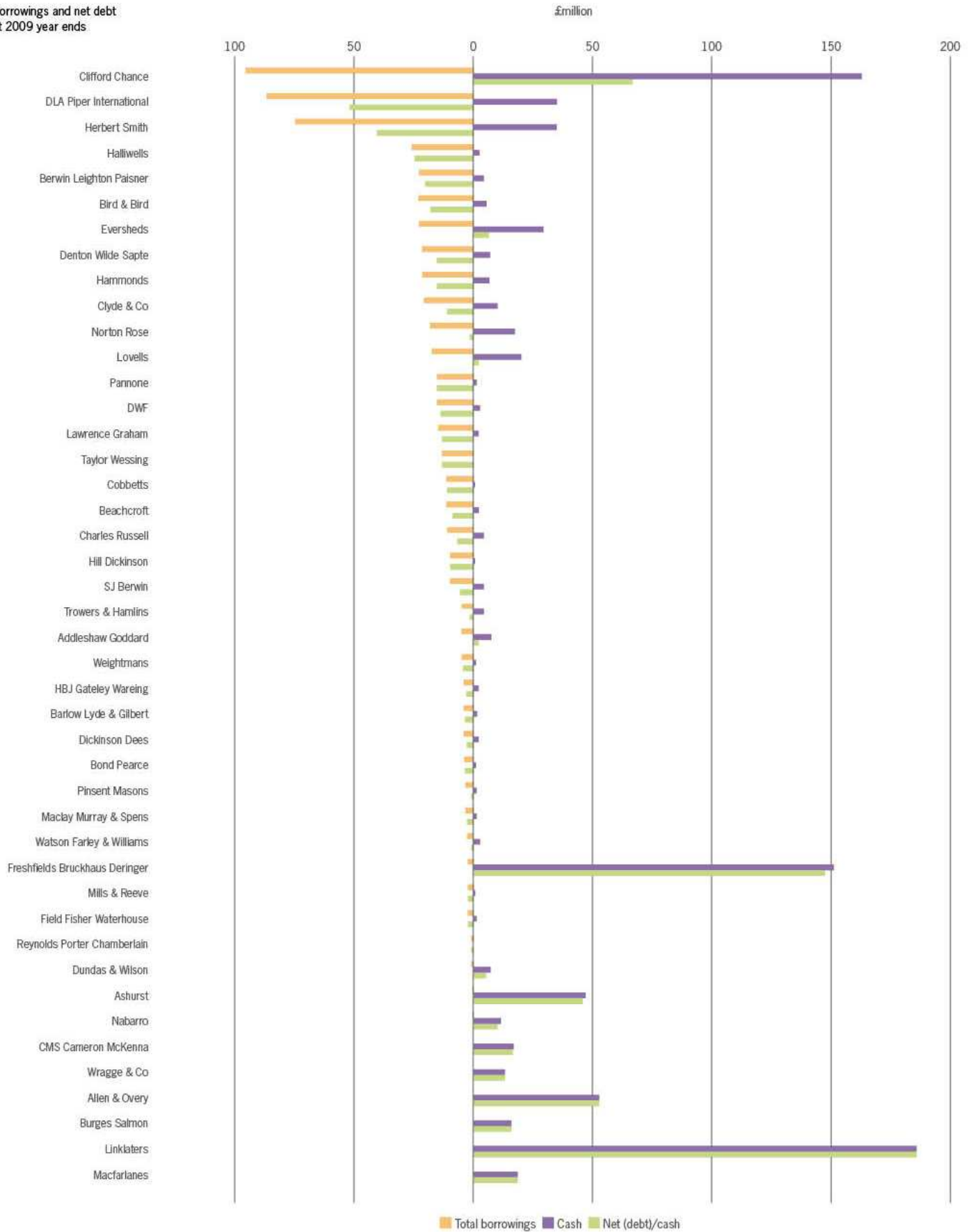
Pressures on law firm profits and the failure of Halliwells have led to a revised, more critical assessment of the legal sector and a consideration of the best way to manage the risk of default.

To this point, many banks have chosen not to provide partner capital loans to firms where they are also the primary lender to the firm itself. Whilst this form of de-risking has been attractive it can result in the bank that provides the corporate facilities having to repay another bank's member capital loans if partners decide to exit en masse, possibly leading to increased exposure to the bank at a time when key partners are departing.

Going forward, will the banks 'de-risk' by not providing facilities for firm and members, or see the provision of the full suite of facilities as the only way to ensure they do not see their money used to repay other banks? We anticipate that banks will continue to ask firms for stronger assurances in this area, perhaps increasing the use of covenants to restrict the repayment of capital in cases where it would fall below a 'predetermined floor'.

Will we see evidence of banks having an increasing preference to take debentures, or to provide the whole of the funding to the member with agreement that they will invest it into the firm by way of capital injection? In the last couple of years, this has been introduced as a concept to some smaller firms, but with the potential for higher profile failures across the sectors it may become more common for firms that are not performing well. This starts to move the individual member away from the low level of personal liability that LLP conversion envisaged – essentially the bank de-risking at the member's expense.

Borrowings and net debt at 2009 year ends



Key considerations for under-performing legal businesses

Banks should consider:

- Loss of key staff (monitoring, lock-in periods, incentivisation)
- Risks to fee income
 - i Client concentration and reliance on key relationships/panel positions
 - ii Level of commoditised work (eg domestic conveyancing and probate)
 - iii Reliance on public sector income (including legal aid)
- Transient nature of work in progress (client billing and general cash generation) requires orderly wind down to maximise realisation
- Property commitments (leases entered into, incentives received including cash or reduced rates)
- Continuing compliance with the Solicitors' Accounts Rules and Solicitor's Code of Conduct as external pressures impact on individuals
- Current accounts and drawings policies - looking at cash extraction and drawings as % of cash flow and profitability

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- Capital base versus underlying costs
- The potential for members' to lose their practicing certificates if their firm goes into administration
- Experience and strength of the management team
- Level of financial control and quality of financial information within the firm, both in terms of regular reporting to the bank and assessment of client profitability

About Grant Thornton – professional practices

Grant Thornton has leading expertise in the professional services sector. We understand the business drivers and the key risks faced by legal businesses in the current climate and that timing is critical in a people business to prevent ongoing value/capital leakage.

Our financial and operational performance plans are focused on the preservation of reputation, the retention and incentivisation of key staff, better cost management, the restructure of service delivery to focus on higher margin work and the divestment of non-performing areas of the business.

If you have a problem in this sector, please do not be afraid to pick up the phone and call us for a confidential and informal discussion on any legal sector issue.

* Our sample included 'top 60' law firms by revenue. From this sample we excluded those law firms which had not filed LLP accounts as of June 2010, those which file accounts in the UK that do not contain the full UK operations (due to group structure) and those which have a year end that is outside of March to May (as the timing of the start of the recession significantly distorts the ability to compare an April year end with, say, a September year end). This gave us a list of 44 law firms. Our analysis is based upon financial periods ending in 2009, as this is the latest year for which there is a significant sample of filed financial statements available.



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