The Science of Successful Mergers

Applying Financial Analytics During the Merger Lifecycle

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In today's legal landscape it's highly likely that your firm will eventually be involved in a merger or acquisition, either as the acquirer or seller. Decisions to merge with or acquire another firm pass through many stages – from setting strategic goals to identifying potential targets and performing due diligence to the final partner votes. Considerations are many and include firm culture, reputations, client base, infrastructure, debt, revenues, compensation, attorney productivity, profitability and more – but there's basically one end goal: to form a stronger, more profitable firm.

The financial analytics and associated planning are often the key science behind the art of the negotiations. Typically, the handling of merger-related financials is largely a paper-based process that poses risks for firms and introduces inefficiencies in time and money. Both acquiring and selling firms can benefit from utilizing sophisticated business intelligence tools and advancing the financial analysis at every stage of the merger process to make sure that their goals are reached.

This article focuses on the financial considerations and analyses that should be performed throughout the merger lifecycle and the technology that enables the most insightful results.

Perform an Internal Audit

The first step in the merger process is to conduct a thorough and honest self-audit of your firm's strengths and shortcomings. Your firm's business is made up of many moving pieces – timekeepers, clients, practices, offices – and the information needed for comprehensive analysis resides in different systems. This necessitates producing numerous reports and manual number-crunching to get a true view of the firm's position and projections for the future.

Pulling together accurate, lower-level measurements can be challenging. For example, even if general trends are positive (or negative) there are typically underlying patterns that may be at conflict with the general trends. It's critical to be able to drill down from the reports into the pieces to identify issue areas and opportunities. That information must therefore be on a multi-dimensional technology platform so that firm trends can be separated into manageable pieces. If an analytic environment is not multi-dimensional by nature, the onus is on your firm's IT and accounting staff to manually define the dimensions and construct queries. Fortunately, the business intelligence tools available today can do this work for you.

From a financial perspective, you should consider the following questions pre-merger:

> ***Measuring client profitability****. What are our profitability drivers? Which clients are most profitable? Would we be at risk of losing any of these clients as the result of a merger? Are there any firms with whom merging would be advantageous in order to keep these clients?*

***Identifying at-risk clients**. Which clients are at risk of leaving the firm? How would attorney attrition affect the client base?*

***Identifying at-risk attorneys**. Which attorneys are at risk of leaving the firm? How would a merger influence this?*

***Understanding productivity.** What is our attorney utilization? Would a merger help or hurt these percentages? How do our targeted hours compare to the industry's norms?*

***Improving realization**. Are billing realization and collections percentages above or below other firms? Can we find ways to bill or collect more quickly?*

***Projecting performance.** What is the trend of hours and profitability over the last one, three and five years? What is driving (volume or rate) the positive and negative financial variances against our budget?*

***Managing expenses**. Where can we trim costs (*i.e., *storage space and leases)?*

***Eliminating debt**. Do we have any debt that negatively impacts our position (*e.g., *unfunded retirement plans, partner compensation debt)? How can we reduce existing debt?*

Good operations go hand-in-hand with good finances. As an acquirer, bringing to the table a strong operational base in practice management, financial processes, marketing and human resources makes you a more attractive partner. As a seller, understanding your business makes you better prepared for the negotiation table and helps you to showcase the complementary benefits your firm brings.

Together with a clearer picture of your firm's financial and operational position you can formulate a strategic focus. Answer the question, "Who are we, and where do we want to be?" This is a critical and often overlooked step that provides two key benefits: first, by understanding your firm's goals you have a yardstick with which to screen and measure potential targets; and second, by pre-establishing your goals you can move more quickly when an opportunity arises. This is important, as time delays often translate into lost deals. You don't want to be right in the middle of a negotiation and have to go back to rethink what you want and where you stand.

Identify Prospects

Once you have an internal yardstick and strategic focus, develop "must have," "like to have," and "red flag" criteria for identifying and evaluating potential targets. Look for firms with complementary strengths. For example, if your firm specializes in litigation for a national client base, you may want to target an IP practice in a geographic location where you already have an office, so as to take advantage of cross-sell opportunities. Once you've determined your criteria, you can create a list of merger candidates and start the dialogues.

From a financial perspective, there is some competitive intelligence you can do to screen potential targets beforehand. Publicly generated statistics track AmLaw 200 firms according to profits per partner, revenues per lawyer and number of attorneys. For smaller firms whose information is not typically published, you may have to rely on reputation and firsthand experience as a starting point. Survey data such as salary or turnover statistics from the National Association of Legal Placement can give you a comparative index when you're looking at firms in new geographies. Deal-oriented databases provide a perspective on the clients and prospects that you may want to target.

***Ann Lee Gibson, Ph.D., a consultant specializing in competitive intelligence and business development for law firms**: "When researching, look at several years' worth of information from databases that track the kind of legal work your firm is seeking to do for the types of clients your firm would like to attract. Then pay attention to lawyers and firms already working for the clients you want to target. Some databases such as LexisNexis CourtLink offer amazingly detailed information about litigation work, including the types of litigation particular lawyers do and the companies they represent."*

Conduct Due Diligence

Whereas qualitative factors such as firm culture and reputation are less tangibly measured, financial due diligence is the quantitative part of the decision-making process and should be as thorough and accurate as possible, given available data and toolsets. The traditional model for discerning whether a target meets a firm's established criteria has historically been through conversations. Typically, the potential seller provides volumes of reports for review (*e.g.*, three years of financial statements). The receiving firm evaluates the information and inputs it into spreadsheets for interpretation. This process usually includes sampling to make sure that the reports are accurate. Given the business intelligence technology available today, this labor-intensive process can be streamlined to provide the greater insights that firms need to protect against risks and make strategic business decisions.

To fully understand the benefits of applying business intelligence tools to pre-merger financial analysis, it's important to recognize the problems inherent in standard, paper-based reporting, including:

*The target firm controls the filtering and definitions that may not match your own (*e.g.*, management hours included in billable time).*

Reports by definition are incomplete, since you're only getting a subset of information.

Paper reports are "flat" and do not provide the ability to dig deeper within the data. They don't provide a mechanism for following up on red flag issues other than a live conversation, which slows the process.

Paper reports are inefficient, as they have to be run and copied, thus generating volumes of paper and creating an administrative burden for both parties. Even if your firm transfers the information into Excel for analysis, the information has to be rekeyed.

Reports vary from firm to firm, making comparative measurement difficult. If the target firm uses a different financial system, report structure or data fields, you may not be able to interpret the results effectively.

A faster and more thorough way of conducting pre-merger financial due diligence is to compile a data request specific to the other firm's systems (*e.g.*, billing and collections), specifying tables so that the data can be received electronically and normalized to your data structures. This data can then be run through an analytic platform modeled in your firm's image. Even if the conversation does not lend itself to getting the data digitally, you can get similar base inputs verbally or in hard copy that allow you to then leverage the standard outputs. Using a multi-dimensional approach, you can analyze the target firm on a standalone basis for a *pro forma* review of material clients, billing timekeepers, working timekeepers, overhead, etc. Once you've developed a *pro forma* on the acquired firm, you can use the information to do an as-merged analysis on the new combined firm. By utilizing the power of advanced analytic tools, you can perform a more thorough and accurate analysis in less time than with traditional evaluation processes.

Whether you employ multi-dimensional analytics, use a database or manually crunch numbers, it's still the evaluation that counts. Focus on areas that will drive revenue (*e.g.*, clients, billable hours, collections) and ones that could potentially offer cost savings (*e.g.*, operational staffing ratios, leases). As a seller, it's equally important to conduct an analysis of the acquiring firm's data. This will help both parties identify financial synergies as well as disparities. The analysis should be iterative. Don't try to get all the answers on the first pass – you'll have wasted valuable time if the deal cannot be consummated. Don't dive all the way to the bottom; dive broadly but shallow. Stop to ask questions and then go in deeper to understand the key drivers. You don't need to analyze everything, only what's most important based on the strategic goals set forth. Identify the important financial issues, validate and understand the data and proceed in a focused manner. The benefit of conducting this review in an automated universe is that you can do multiple analyses instead of one lengthy analysis.

***Lisa Smith, Director and Merger and Consolidation Group leader for Hildebrandt International**: "We typically look at the current year's budget, as well as the financials for the three years prior. It's important to consider the variables such as how each firm measures profits and how partnerships are structured. For example, you could have firms with different incomes per equity partner, but they may actually have similar compensation. Similarly, geographic differences can affect the numbers. If a firm in Cleveland and a firm in New York City both have average revenues per lawyer of $400,000, the firm in New York City is probably not as strong a firm given its market."*

Another key technique in quickly understanding a target's business is to develop an automatic scoring system as part of your top-level financial evaluation. Scoring methodologies should include a series of measures encompassing the key profitability drivers and focus on accountability. For example, client scores from A to D can be generated using a combination of billing realization or margin, collection speeds and size. Billing attorney scores should derive from the key financial metrics that they control – billing speeds, leverage, client discounts and the scores of their clients. Finally, productivity and direct margins can be used to analyze the working timekeepers.

Use the data to develop rankings for practices, offices, clients and billing attorneys. This is an important way to identify what to keep and also what you may be at risk of losing. Keep your firm's goals in mind and override lower "grades" if they do not detract from the pre-determined strategic focus. For example, an important segment is the intersection between billing attorneys at risk of leaving but whose clients you need to retain. This list enables you to proactively formulate a plan

to maintain those clients, even if the billing attorney leaves on your terms or of his/her own volition.

Be on the lookout for red flags such as capacity issues (*e.g.*, under or over-utilized attorneys), work ethic differences (*e.g.*, billable hours per attorney), realization differences and compensation disparity. Also, be wary of recent changes such as fewer thriving clients, lower productivity or declining effective prices. By methodically moving between the client and attorney views and evaluating the trends you'll not only improve your due diligence but also better plan for Day One following the merger.

***John Smith**, **Chief Operating Officer at Ogletree, Deakins, Nash, Smoak & Stewart P.C.**: "Real estate, debt level and retirement obligations need to be assessed early on. We find it helps immensely to have some parity between the firms, and we try to look at the numbers on a consistent basis – billable hours, effective rates, compensation and revenue. Our objective isn't just to add attorneys or office locations but to create complementary practices and client synergies – a win-win where we can be successful together. So we spend a great deal of time looking for those opportunities together."*

Of course, technology alone shouldn't eliminate face-to-face conversations, but it can change the nature of those discussions and help the parties focus attention on the issues that should be covered. Many negotiations start with easy points and push problem areas to the back burner. This can lead to dead-ends and wasted efforts. Start with the non-negotiable or potential deal-breakers rather than waste time on a deal that cannot be consummated. Most importantly, remember that negotiation is not a transaction – it's the first step in the relationship. Manage upfront conversations in line with the way you would treat an existing partner. Be candid with the other party about your intentions and objectives and look to build value for both parties.

Integrating People and Processes

Successful mergers involve a tremendous amount of operational planning, such as blending HR or client intake processes, training attorneys and staff, consolidating technology systems and monitoring financial measures. "We're always looking for better ideas," according to Ogletree's John Smith. "We learn something each time we look at another firm." Smith adds that integrating attorneys and billing rate practices can take time. "In markets where rate increases are appropriate, we would implement them over time to avoid sticker shock. However, we have some attorneys join us because we have a more competitive rate structure than their current firm."

Once you've decided to merge, how do you get off to a fast start and build post-merger momentum from a business development perspective? Since you're acquiring the merged firm's history, including their past and existing relationships, another area in which business intelligence tools can be utilized is to mine both firms' active and dormant clients for sales opportunities. Your marketing department can mitigate risks by identifying clients at risk of leaving the firm and by predicting the impact that the lost revenues would have on the firm, then seize opportunities by targeting clients that offer the most revenue potential and leverage marketing dollars accordingly.

Measuring Success

Post-merger analysis can be difficult and is rarely done to the extent that it should be, because from a cultural perspective merged firms don't retain separate identities. Most firms don't want to talk about legacy firms – especially not the legacy firms themselves, since that is divisive to the culture of the new firm. However, not analyzing post-merger performance is a lost learning opportunity and may leave cash on the table. Find a way to analyze what *occurred* compared to what was *expected*, so you can make adjustments for both the future of the existing firm and in future merger target identification and negotiation. To avoid divisiveness, the results need not be shared broadly, just with those who will be involved in future acquisitions. Understand that while it can take a few years for the firms to fully integrate and produce desired results, you can be learning in the interim.

To determine if the merger is producing results:

> ***Code** for a year the original source of clients and prospects by firm, responsible attorney or other mechanism and track if new business has developed as expected.*
>
> ***Evaluate** how the cost of the acquisition and its integration impacts short-term profits.*
>
> ***Quantify** the pace of the integration of processes and systems, so that in the next deal you can fine-tune your work plan to yield quicker results and more substantial savings.*
>
> ***Measure** success based on how the type of work you're doing, new clients and lawyers measure up to the firm's strategic goals.*

Both sides of the negotiation table can benefit from utilizing business intelligence tools to dig deeper during due diligence. By performing a thorough financial and client analysis throughout every stage of the merger lifecycle, your firm can avoid pitfalls and maneuver effectively to reach strategic goals, thus improving the likelihood of a successful merger.

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