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The Clementi Review has opened the way for law firms to float, but what are the dangers? Matt Byrne reports



"There would be considerable benefit in permitting outside owners of legal practices." So said Sir David Clementi in his legal services review report, thus potentially kick-starting the most radical change in the financial management and ownership of law firms for decades.

For Clementi, the total overhaul of legal market regulation was, of course, the prime focus. But the opportunity for non-lawyer, third-party owners to buy a portion of a firm, or even the distant possibility of a firm floating on the stock exchange, is among the more radical possibilities.

The theory is that fresh capital and fresh ideas would increase competition and provide a better deal for the public. As the report outlines: "In general economic terms, new capital from outside the industry would be permitted, which should increase capacity and exert a downward pressure on prices. In a business sense, new investors might bring not just new investment, but also fresh ideas about how legal services might be provided in consumer-friendly ways." Despite the positive noise, there is much scepticism in the market about the prospects of a law firm listing. McGrigors corporate finance partner David Mandell, for example, questions whether law partnerships are "organically capable" of floating, although he admits to being pro in principle.

In practice, how likely is it that any firm would be willing to sell itself for a quick buck? And what are the key financial and management issues a sale or float would create?

The sale of accountancy consolidation market trailblazer Numerica two weeks ago is the latest in a series of professional services-related trade sales and AIM flotations. The deal is proof that such deals are entirely possible. Numerica was bought in a two-way £15.8m deal by competitor Vantis and BDO Stoy Hayward. The deal valued Numerica's equity at £15.8m, while Vantis agreed a separate deal giving BDO Numerica's Bristol, Manchester and Southampton offices in return for £12.1m cash.

Another recent deal closer to the legal market saw the trademark and IP group Hallmark IP acquired by consultancy Nucleus. An AIM listing for the new company is certainly a possibility, but it is a path already trodden by patent business Murgatroyd Group, which recently floated on AIM with a market capitalisation of some £15m.

Post-Clementi, it can be only a matter of time before the first law firm gains the kudos, however dubious it may eventually prove to be, of



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being the first to float.

How to value a law firm

So how does an investment bank or private equity house value a law firm? Similar evaluation methods would be applied to a law firm as to any other business, including a multiple of current earnings, discounted cashflow of the contracted income and the value of the asset base (including work in progress (WPP)). But a law firm's major asset is its people, which means it is, as one private equity professional quips, "a business in which the quality of earnings is driven not only by the economy, but also by the prima donnas who can move around at will".

With law firms, there are additional specific issues that need addressing. As with any company listing, the market would look at the expected future growth of the business and the likelihood of the business paying dividends. "Most law firms distribute most of their profits to the partners every year, which means the earnings available for any external shareholder are zero," says KPMG Corporate Finance partner David Simpson. "That means partners would need to agree to put a portion of the profits aside if it was listing."

Justin Lewis, chief executive of brokers Corporate Synergy, says: "The starting point for valuing law firms is a multiple of profits. Then you have to normalise it back. The multiples will be comparable to other professional services firms."

Steve Tudge, managing director of private equity house ECI Partners, outlines the wide range of factors that would be considered in any law firm valuation. "They'd include the scale of the business, the quality of the management team, the current gross and net margins, the extent of contractual underpinning to revenues, the spread of contracts, the visibility of the earnings growth from the existing income sources and the pipeline of new opportunities, the quality of the operational systems, and the asset base - fixed assets, WIP and so on."

Appetite and pitfalls

The likelihood of one of the UK's largest firms selling a chunk of the equity to a third party seems remote. As the head of professional practices at Baker Tilly George Bull explains: "The top 100 firms, and certainly the top half, are unlikely to be candidates for a wholesale sell-off. Their business streams, with the heavy transactional bias, and the fact that the new owner would almost certainly be in the financial services sector, means there's a certainty of large conflicts."

The chances of a firm going public also appears unlikely. "When you're a listed company you're doing two jobs," says KPMG's Simpson. "You're running your own business, plus you're informing and educating the market as to how you're doing. That means there's an additional glare of publicity on partner earnings and performance. I don't think too many firms or partners will be that comfortable with that scenario."

On top of that is the lack of incentive for future generations of lawyers. "The issue is retention of people," says Lewis at Corporate Synergy. "If you've given it away to one generation, the Holy Grail, the IPO [initial public offering], has happened, so what is there to work for?"

Set against that is the short-term gain of the current crop of partners, as shown by Tenon's October 2001 acquisition of music boutique Statham Gill Davis. Each of the equity partners made a tidy £700,000, although half was on paper. As one senior partner of a City firm puts it: "If I'd been offered a deal like that I'd have bitten their hand off."

There is also clearly an appetite among private equity houses for a piece

of the legal market action. As Tudge at ECI puts it: "The traditionally structured firms that dominate the market - relatively small, local, heavily partner-led and dominated - are unlikely to be interesting to private equity. Of much more interest is the bulk legal services part of the market and particularly those firms where the revenues are underpinned by ongoing contracts. This market currently has a fragmented supplier base - the private equity opportunity would be to back a team to lead a consolidation play. This would involve buying a number of businesses, improving the efficiency and effectiveness of operations and winning new contracts."

Like any new invention, if someone can think it, you can probably do it. So lay your bets now on which firm will be first to attract the private equity money following the introduction of Clementi's reforms. As for floating, Simpson's advice is: "Only go public if it's a marked improvement on any other option. You have a moral duty to generate returns."

The concerns

Clementi raised a number of issues that arise when management and ownership are split. They are:

- . concerns about inappropriate owners;
- . concerns that outside owners would bring unreasonable commercial pressures to bear on lawyers that might conflict with their professional duties;
- . concerns that new owners would cherry-pick the best business;
- . concerns that legal disciplinary practices (LDPs) could jeopardise access to legal services in rural areas;
- . concerns that new owners would have conflicts of interest;
- . issues about whether some restrictions might be placed on the nature and extent of the owner's interest in the LDP; and
- . concerns that there is no precedent for such outside ownership.

How to value

Peter Matthews, managing director of brand experience consultancy Nucleus, which has just acquired trademark specialist HallMark IP, believes there is an established methodology for valuing people businesses, such as design and advertising agencies, that can easily be applied to legal services.

"In valuing any business one looks for quoted comparators to establish some key ratios as the basis for a valuation," he says. "In the trademarks world, the only quoted company I can think of is Murgatroyd Group, so I'd start by looking at their pre-tax profit before exceptionals - approximately £1m - and their market capitalisation - approximately £15m - and translate that into an earnings multiple. This establishes a potential earnings (PE) benchmark of 15 times pre-tax profit. I'd then look at the acquisition or flotation candidate and identify key reasons to apply discounts or premiums to that benchmark. These would include:

- . are the revenues and profitability over the past three years on a growing or diminishing trend?;
- . how firm are the forecast revenues?;
- . what are the free cash balances and other balance sheet assets?;
- . are debt and other liabilities, such as onerous leases or pension deficits, a factor?;
- . what is the spread of clients and length of client engagements?;
- . is staff turnover within industry standards and are the terms of employment for key individuals watertight?;
- . how many shareholders and partners are there?; and any other major factors that are likely to influence the future of the business, such as


key people leaving or retiring.


"A privately-owned company with illiquid shares will always attract a discount to a publicly quoted company where the shares can easily be traded, while a flotation valuation would be comparable.

"I would then weigh up the premiums and discounts and, unless this is a very fast-growing company, you'll probably end up with a discount to the publicly traded benchmark. This could be as little as 20 per cent or as high as 80 per cent, depending on the factors involved. For illustrative purposes, if the discount was 50 per cent, the PE would be 7.5, and this multiple would then be applied to the pre-tax profit figure and an initial valuation would be achieved. In the past, forecasts were used to calculate, but now investors are more prudent; run-rates or historic pre-tax figures are preferred.

"The key risk for an acquirer or investor is going to be locking in all the main assets - the key fee-earners and rainmakers. In any people business, the key assets can literally walk out of the door, often with the client relationships within their influence - this is a big turn-off for acquirers or investors. Expect lock-ins and restrictions on selling stock for a prolonged period if you're thinking of a flotation, or heavy discounts to counter the risks in a trade sale.

"The public markets have had love-hate relationships with people businesses, and those that succeed in creating value for shareholders post-initial public offering, such as Accenture, have tended to quickly transform themselves from businesses that make money from the peaks and troughs of consultancy to annuity revenue businesses with more predictable revenue streams, such as outsourcing or managed services. Whether or not legal multidisciplinary partnerships will find favour with the markets will depend on the early attempts at flotation delivering on these performance criteria. An early flop will colour the views of the ever-fickle analysts and fund managers for a very long time."

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