

View from the outside

William Arthur discusses the new frontier of law firm investment after the implementation of the Legal Services Act

Much time and many column inches have been devoted to the Legal Services Act and possibility of outside investment into law firms, but very little attention has been given to what that brave new world might look like for the investor.

One might say that view depends on what the investor is seeking, which depends on various factors including the size, position and type of law firm, as well as the particular investor – for instance, the alternative investment and main markets, local business, specialist/private equity fund, or supply chain strategic investor (such as supermarkets).

Space does not allow a full exploration of these differences; therefore, I will address the subject in general terms. Suffice to say, all investors seek safe havens for their cash to make a good return on their capital (or better than can be obtained elsewhere and relative to the risk), either by cash flow, capital growth or both. The investor's view will probably be short to medium term (up to five years), but one can certainly imagine that a strategic stake by a large insurer, membership organisation (such as the AA) or supermarket chain may be made as part of a long-term plan (up to 10 years).

The prospective investor must first have a group of partners ready and willing to share profits. Although I have heard many firms discuss third party stakes, they rarely articulate it in a way that proves they fully think it through. How much of the business would be sold? What would be the price of that stake, both financially and in terms of representation (or perhaps interference) in the business? Indeed, despite the flotation of Slater & Gordon in Australia, no established methodology exists for calculating a value for a legal business, and the obvious danger revealed is a mismatch of expectations.

Equity capital remains expensive, and there has never been a shortage of relatively cheap bank funding in a sector where the banks compete fiercely. A sophisticated investor expects to hear a pretty cogent explanation as to why the firm might need or want to raise funds in this way, in addition to what purpose the funds would be put. In some

firms this might cause problems, at least initially, because partners have always been answerable only to themselves. Putting a powerful business case together for an unknown third party would be a challenge for many firms with no previous external perspective.

Therefore, a good investor wants to know what the firm will do with the money and how this stake will enable the business to achieve more than was previously possible, thus providing a return that satisfies all of the owners, old and new. Many of the firms to which I have spoken that say they would consider outside capital are not sure how they would answer this question. "Growing the business" is pretty vague, and an investor will be more readily drawn to a clear strategy showing the planned acquisition of resources, technology or people, or entry into new markets, supported by well-reasoned financial projections showing the "payback". Indeed, some firms may have a completely different motivation, seeking the outside stake purely to replace or release some of the partners' own capital and establish a value on their goodwill. In such cases, the investor will be very keen to be convinced of the partners' continuing commitment to the business.

This assumes, perhaps, that our investors understand a law firm and what makes it tick. Bearing in mind the lack of a track record of investment into law firms, as well as some fairly strong recent evidence that the markets do not really understand the few listed professional service firms and the lack of any real focus on the sector, that assumption looks rather bold. I think the firm and investors will need to hold each other's hands through this process, in equal measure.

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FOODFOR THOUGHT

Partners must be genuinely committed to supervision, communication and performance management: nothing else will do.

Source: Heather Stewart, Otterburn Legal Consulting



are definitely improving in this sector, but still I have recently seen MI ranging from outstanding to embarrassing.

Partners may be happy with superficial, incomplete or untimely information, but an investor is unlikely to be impressed.

The investor will not be pleased with great MI or KPIs unless he or she also sees it linked to a robust performance management system. Currently, too many firms possess no such system, which means that poor performance or behaviour can be ignored, and good performance is not sufficiently recognised, celebrated or rewarded. This is a key lever for any business, but professional partnerships have come to recognise this only quite recently. Things are changing for the better, and some firms have gripped the nettle very well. For the investor, I think this will be an important differentiating factor.

Another important area is structure. Notwithstanding the clear expectation that firms will only wish to sell a modest proportion of the business (I have heard 25 per cent several times recently) and the requirements of the regulator, our investor will expect to see a sensible business structure and robust business strategy, a balanced board clearly mandated to make decisions and a chief executive or managing partner with sufficient delegated

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authority to carry them out. This may be a little uncomfortable for a group of partners who have always expected a high level of consultation. It will still be important, of course, as the partners will remain key assets and stakeholders of the business (although their titles may change) and need to be involved and informed appropriately. However, I think our investor may be uncomfortable unless he or she sees a clear separation of the partners' roles as owners and senior executives.

The quality of leadership within the firm will be a key influencer of the outsider's decision to invest. He or she must have confidence in the firm's leadership ability to deliver the business objectives and grow the value of the investment. Unfortunately, the nature and history of professional partnerships has not been conducive to the development of strong leadership skills. Though some law firms have outstanding leaders, I think they have succeeded in spite of the system, not because of it. This means that leaders in firms often survive on sheer intellectual ability without having had the experiences, training or development that could help them be the best. This remains an issue of which firms must be aware and seek to improve, particularly because the leaders are likely to be the agents of considerable cultural and behavioural change (the most difficult).

It is impossible to predict how many firms will seek outside investors. Clearly, the investment community shows strong appetite, but I think the success firms may have in gaining the right investor and the right deal depends on how convincingly they can project their readiness and ability to drive the business. My feeling is that at first very few firms will go this way, but you can bet that everyone else will be watching them very closely, and if they are successful it will cause a rush. At this moment, I think few firms are actually ready to go, but by the time the regulatory framework is properly in place, I expect there will be more: quite an exciting prospect.

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