



Evolution and growth...

In the second of a series of professional practice sector updates for the UK legal services industry, BTG Global Advisory looks at the main factors driving growth and how alternative business structures will continue to change the face of the profession.

According to the Solicitors Regulation Authority (SRA), the UK legal services market is the largest in Europe with a 7% share of the global legal market. With a large trade surplus and employing over 316,000 people, legal services represent a major and growing contribution to the UK economy. Following market liberalisation, legal services provision continues to evolve towards a new business model, driven by globalisation, advances in technology, commercial competition and changing client expectations.

Market Analysis

The Competitive Environment

The global legal market has seen large firms expanding and merging to create global entities, driven by an increasingly multinational client base.

There is greater competition for regional work, with more US and European firms opening London offices.

At the other end of the scale, there is widespread commoditisation of volume work, niche and specialist boutiques are thriving and high-profile partners continue to leave big international firms to launch or join them.

The squeeze is in the centre where mid-market and smaller firms face increased competition from alternative business structures (ABSs) created by market liberalisation. In terms of competition for work the lines are blurred too. Price pressure has prompted big City firms to launch low-cost regional centres and top regional firms to establish City bases to compete for the most lucrative deals.

Growth and Profitability

UK firms are significantly more profitable and achieve higher margins than their international counterparts – the next most profitable are law firms in Australia and Western Europe.

Notwithstanding market liberalisation, the legal sector saw cautious growth in real turnover, which stood at 3.5% in 2013 and is forecast to improve to 3.8% in 2014 and 4.9% in 2015, which is close to pre-recession levels. This reflects the upward revisions to the outlook for the UK economy by macroeconomic forecasters. (Source: The Law Society)

The main factors driving growth in legal services real turnover in 2013 and 2014 were the improvement in the performance of the UK business sector and increased housing market activity. These are expected to continue to be significant drivers of growth in legal services real turnover in 2015.

Turnover at UK's top ten law firms hit £10.643bn at the 2013/14 year end. At firms outside the magic circle – Clifford Chance, Linklaters, Freshfields Bruckhaus Deringer, Allen & Overy, and Slaughter and May – growth has been driven by mergers and acquisitions over the past ten years. (See table on page 2)

Other research supports these findings. *Legal Business* magazine reported total revenue for the top 100 firms increasing by 9% while lawyer headcount rose by 6% and average revenue per lawyer, profit per lawyer and profit per equity partner increased by 3%. The top 25 firms posted the fastest revenue growth, although turnover was inflated by large-scale mergers.

Profit margins increased in 2014: 58% of firms recorded profit increases at a higher rate than the increase in fee income, compared with 45% in 2013, and the number of firms reporting both fee income and profit reduction is just 7% this year (2013: 25%).

Turnover: UK Firms 2013/14

| Rank | Firm | 2013/14 Turnover (£m) |
|------|--------------------------------|-----------------------|
| 1 | DLA Piper | 1,566 |
| 2 | Clifford Chance | 1,359 |
| 3 | Linklaters | 1,255 |
| 4 | Allen & Overy | 1,234 |
| 5 | Freshfields Bruckhaus Deringer | 1,232 |
| 6 | Norton Rose Fulbright | 1,152 |
| 7 | Hogan Lovells | 1,070 |
| 8 | Herbert Smith Freehills | 800 |
| 9 | CMS | 715.19 |
| 10 | Ashurst | 586 |

Source: *The Lawyer*

Law firm profitability at the high end of the market was boosted by increased deal activity and value in 2014, which was the strongest year for M&A since 2007. The top global legal advisers were all US firms, headed by Weil, Gotshal & Manges and Simpson Thacher & Bartlett. Freshfields Bruckhaus Deringer was the top ranked UK firm, and Slaughter and May, Linklaters and Allen & Overy all appeared in the top 20 in terms of deal value. UK deal volume increased 5% in volume and 31% in value. Slaughter and May topped the rankings, which again were dominated by US firms, particularly in terms of deal value. (Source: Thomson Reuters)

Consolidation and Mergers

Notwithstanding the recovering global economy and the uptick in transactions, the legal sector continues to consolidate. According to Altman Weil, the first three quarters of 2014 saw more mergers than in any year since 2007. (See table on page 4)

Mergers involving major global players relate to extending their global footprint or establishing a presence in a significant jurisdiction. Herbert Smith Freehills and SJ Berwin's mergers brought Australian and Chinese presence to long-standing City firms. A merger is a quick way into new and emerging markets. International firms like DLA Piper and Bird & Bird are two examples of firms extending their global footprints through mergers with local firms.

In the mid-markets, mergers create firms with sufficient bandwidth to compete for lucrative bigger-ticket work. For example, the merger between Morgan Cole and Blake Lapthorn into Blake Morgan in July 2014 created a top 50 firm.

Other mergers are driven by the mid-market's struggle to hold off competition from commercial ABSs and from national firms looking down the food chain for lucrative work. Sometimes the match is obvious, but others are clearly distressed mergers – and not all of them go ahead, particularly when regional and specialist firms unexpectedly look for liaisons from a range of different quarters.

However, the UK appetite for mergers is not reflected in the US legal market, due to a combination of factors, which include regulations that prohibit placing restrictions on a client's right to choose his or her lawyer – meaning the individual partner rather than the firm. Consequently, lateral hires tend to bring their key clients with them. Litigation involving law firms is another deterrent to US mergers.

Market Liberalisation

The Legal Services Act 2007 introduced alternative business structures (ABSs) which allow lawyers to form multidisciplinary practices with other professionals and non-lawyers to own and manage legal services providers. This has led to a proliferation of business models.

Some ABSs are technology driven – deploying the latest document automation software to offer self-service offerings. Others apply business models from other sectors to legal services, in some cases with measurable success: Australia-listed Slater and Gordon's net profit after tax rose 47.2% on 2013 figures. Others have proved less successful. Stobart Barristers, launched in 2012 by trucking business Stobart Group, closed its business in May 2014.

The UK market has seen private equity investors in law firms change the shape and strategy of the business. Two examples are Knights Solicitors, backed by private equity investment from former Dragons' Den investor James Caan's private equity house Hamilton Bradshaw, and Parabis, backed by Duke Street, the first private equity investor to enter the legal market.

It should be noted that ABSs represent less than 3% of the UK legal market. According to the latest figures from the SRA, there are just 339 licensed ABSs compared with an estimated 11,000 law firms. However, in just a couple of years ABSs have achieved a significant share of particular areas of legal work and are rightly recognised as a threat to established practices. According to the SRA, they account for one third of turnover in the PI (personal injury) market. It is also worth considering the observation by Sir Nigel Knowles, global co-chief executive of DLA Piper, in a recent article for *The Lawyer* that this could be because legal services remain fragmented, with no individual firm having more than a 1% market share.

The anticipated multidisciplinary practices combining legal practices with other services have, by and large, not materialised, although this may change with the re-entry of the Big Four accountancy practices into the legal sector; however, there are indications that the regulatory environment needs to be adjusted to facilitate multidisciplinary practices.

The past 18 months has seen three of the Big Four accountancy practices gain ABS licences and in August 2014 the Institute of Chartered Accountants (ICAEW) became the first non-legal entity with powers to regulate probate services and license ABSs.

Whereas most ABSs have concentrated on commoditised volume work, global consultancies are looking to compete with the mid-markets. However, regulatory issues present a challenge in that an accountancy firm wishing to provide legal services would need to be regulated by the SRA.

Drivers of Change

Price Pressure

Client expectations have changed and value for money is top of the agenda. While the volume/lower end of the market moves towards fixed price, self-service business models, corporate and commercial firms are increasingly involved in alternative financing arrangements (AFAs) which include fixed, capped and discounted fees.

Notwithstanding the improving economy, corporate counsel are looking closely at the value proposition; they are bringing more work in-house and making greater demands on their external advisers. Price pressure remains a feature of many panel reviews, and looks set to be the new normal. It is forcing law firms to align their pricing models with client preferences, heralding the end of hourly billing in all but high-end and niche services. Moving away from hourly billing has led to a focus on productivity and efficiency, and strategic priorities and investments are shifting towards project and resource management, including business process re-engineering.

The War for Talent

While the number of firms is decreasing, many firms are increasing their headcount. London's magic circle firms are fighting off US firms looking to recruit top talent. US firms are beginning to dominate the London mid-tier and this is leading to higher remuneration for top rainmakers and an increase in high-profile lateral hires.

Cuts and Regulation

Cuts in legal aid have challenged firms that operate in particular sectors, and although the justice gap has driven innovation in some quarters, it has created difficulties in firms that focus on legal aid work.

Complying with (and keeping up with) changing rules and regulations from the Legal Services Board, the Law Society and the SRA is another costly and time-consuming activity. For example, the SRA requires firms to appoint Compliance Officers for Legal Practice (COLPs) and for Finance and Administration (COFAs) to manage risk and regulatory compliance as part of the shift to outcomes-focused regulation. The SRA is considering whether the current regulatory environment is too onerous for smaller and mid-sized firms in the face of commercial competition.

The Law Society Gazette highlights the fact that the lack of flexibility over professional indemnity insurance (PII) and the fact that actions against solicitors nearly tripled in 2014 may also prove a threat, particularly to smaller and mid-market firms. LLPs and ABSs must have at least £3m cover for any one claim and sole practitioners and partnerships must have at least £2m for any one claim in compulsory cover. It has not helped that the SRA and the LSB have failed to reach agreement over this.

Additionally, smaller practices are facing additional costs associated with changes to payroll rules and the introduction of auto-enrolment pension legislation.

Technology

Technology is transforming legal services delivery. Cloud computing helps bigger firms become more agile, making it quicker to open and close offices and enables smaller firms and start-ups to access enterprise grade software without having to make capital investments. Mobile technology allows lawyers to access their firm's systems remotely via a multitude of devices. It is transforming client service, giving clients instant 24/7 access to the progress of their matters.

Technology-driven ABSs which implement automated workflow technology and apply data analytics across the business have influenced their mid-market law firm competition in two ways: to explore software solutions that boost their business, and to use online and social media to promote the local expertise and personalised approach that differentiates their services.

Technology has changed legal services with ABSs and law firms offering self-service features such as online forms and services that people can access before making contact with a lawyer and incurring charges. In the corporate world, collaboration software allows clients 24/7 secure access to their matters. File encryption and e-signatures mean documents can be sent and signed securely online and online video conferencing via Skype or Lync reduces the need for business travel without incurring massive call charges.

Diversity

Although law firms recruit slightly more women than men, the gender balance declines significantly at partnership and senior management level and there is a tendency for women to leave private practice for in-house roles. In 2014 several UK firms made commitments to reach 30% female partnership within the next few years. Linklaters was the first magic circle firm to set gender diversity targets, aiming for 20% of its executive committee and international board to be female by 2018. BLP is aiming for 30% female partnership by 2018, Taylor Wessing 25%, and Norton Rose Fulbright 30% by 2020.

Looking Ahead: Threats and Opportunities

ABSs represent an ongoing threat to firms at the commoditised end of the market. As we go to press, LegalZoom becomes the first US company to gain an ABS licence, working in partnership with law firm network QualitySolicitors.

Consolidation is likely to continue. As Sir Nigel Knowles wrote in *The Lawyer*: "There are simply too many firms (and, inevitably, too many lawyers) offering services without any clear differentiation. Consolidation is a certainty." He anticipated more firms involved in mergers to gain greater geographic exposure, particularly in Africa and Asia, and this is already happening. (See table on page 4)

2014 Legal Sector Mergers and Acquisitions

| Report Date | Firm 1 | Main Office | Total Lawyers | Firm 2 | Main Office | Total Lawyers | Post Merger Name |
|-------------|-------------------------|--------------|---|---------------------------------|-------------|---------------|------------------------------------|
| 12/12/2014 | DMH Stallard | London | 76 | AWB Partnership | Guildford | 37 | DMH Stallard |
| 06/11/2014 | Irwin Mitchell | London | 526 | Berkeley Law | London | 9 | NA |
| 02/11/2014 | Eversheds | London | 1,218 | Juridia Butzow | Helsinki | 102 | JB Eversheds* |
| 28/10/2014 | DLA Piper | N/A | 4,200 | Gallastegui y Lozano | Mexico City | 7 Partners | DLA Piper Gallastegui y Lozano* |
| 20/10/2014 | Bird & Bird | London | 918 | Truman Hoyle | Sydney | 24 | Bird & Bird |
| 06/10/2014 | Shepherd and Wedderburn | Edinburgh | 225 | Tods Murray | Edinburgh | 79 | Shepherd and Wedderburn |
| 26/09/2014 | Berrymans Lace Mawer | London | 440 | Campbell Fitzpatrick Solicitors | Belfast | 21 | Berrymans Lace Mawer |
| 02/09/2014 | DLA Piper | N/A | 4,200 | Haškovcová & Co | Prague | 9 | DLA Piper |
| 11/08/2014 | Harper Macleod | Glasgow | 121 | Bird Semples | Glasgow | 14 | Harper Macleod |
| 16/07/2014 | Charles Russell | London | 273 | Speechly Bircham | London | 195 | Charles Russell Speechlys |
| 07/07/2014 | Hogan Lovells | London | 2,280 | BSTL | Mexico City | 70 | Hogan Lovells |
| 02/05/2014 | HowardKennedyFsi | London | 184 | CKFT | London | 7 Partners | HowardKennedyFsi |
| 28/04/2014 | Gordon Dadds*** | London | 30 | Davenport Lyons | London | 81 | NA |
| 09/04/2014 | Dentons | NA | 2,600 | KapdiTwala | Cape Town | 5 | Dentons |
| 20/03/2014 | Blake Lapthorn | Southampton | 234 | Morgan Cole | Cardiff | 170 | Blake Morgan |
| 18/03/2014 | Sutherland | Atlanta, USA | 422 (Non-UK 100 Merger, AmLaw 100 Firm**) | Arbis | London | 5 | Arbis Sutherland* |
| 17/03/2014 | Berrymans Lace Mawer | London | 408 | HBM Sayers | Glasgow | 30 | Berrymans Lace Mawer |
| 04/03/2014 | Bircham Dyson Bell | London | 103 | Ambrose Appelbe | London | 12 | Bircham Dyson Bell |
| 07/02/2014 | Field Fisher Waterhouse | London | 321 | Heatons | Manchester | 20 | Field Fisher Waterhouse |

Publicly reported mergers involving UK-based law firms in the Lawyer 100 or which are likely to be in the Lawyer 100 as a result of their mergers.

Source: MergerLine UK developed by Jomati Consultants LLP

* Name change only for Firm 2.

** Merger is not between Top 100 UK law firms, but is significant to the UK legal market.

*** Merger may result in a Top 100 law firm by revenue.

Knowles suggests that the firms that will survive and thrive will be “either truly global or highly niche”, and that all firms will need to focus on motivating and retaining their leading players.

2014 saw a few well-known names disappear, notably Tods Murray and Davenport Lyons. The knock-on impact of legal aid cuts, regulatory changes and price pressures along with a potential increase in interest rates may well lead to further insolvencies. Nor were ABSs problem free, with Co-operative Legal Services (the first consumer brand to enter the legal sector) posting £5.1m losses for the first half of 2014. However, as was recently pointed out in *The Law Society Gazette*, law firm numbers fell by just 250 in 2014 and there were no failures among the top 100 firms.

The prospects for 2015 are optimistic. The economy is recovering and deal activity continues to be strong. Half-yearly financial results posted in December 2014 show healthy increases in revenue compared with the previous financial year. *The Lawyer* reported that nine of the UK’s biggest firms show an average increase of 10.8% over the previous half year and 9.3% over 2013–14 full-year revenue. The Law Society too predicted an uptick in both revenue and exports for the UK legal sector in 2015 and beyond. However, change has become a constant and firms recognise that they require greater commercial awareness to compete successfully in the new legal landscape, and run their operations in a more business-like way, focusing on profitability and competitive advantage.