



Mergers and margins...

In the third of a series of professional practice sector updates for the UK legal services industry, BTG Global Advisory looks at the changing shape of the industry as it emerges from the recession into a broader competitive environment with specific challenges facing different industry segments.

The UK legal sector generates £22.6bn, or 1.6% of the UK's gross domestic product and directly employs 316,000 people, two-thirds of them located outside London. The sector's trade surplus totals over £3bn, helping to offset the UK's trade in goods deficit.

The UK is the leading global centre for international legal services and dispute resolution, accounting for 7% of global legal services fee revenue and 20% of European fee revenue. And 27% of the world's 320 legal jurisdictions use English common law. Three of the world's five largest law firms based on headcount are headquartered in the UK and five of the world's ten largest law firms based on gross fee revenue have their main base of operations in the UK. Two hundred foreign law firms have offices in the UK – half are from the US.

Market (UK and Global)

The world's top law firms are recording healthy turnover and profit margins, reflecting high international deal volumes. The past year saw major expansion among international firms, both by office and jurisdiction. This raises challenges and opportunities.

Mergers are a key factor. In terms of legal work, global merger volume surged in 2015, producing an uptick in lucrative M&A work for corporate law firms. The global legal market itself also saw a record number of international mergers and alliances, reflecting the demands of its multinational client base by enabling firms to cover additional jurisdictions and emerging markets.

An extreme example is Dentons, which in 2015 became the world's largest law firm following its mergers with China's Dacheng, US firm McKenna Long & Aldridge, Singapore's Rodyk & Davidson LLP and Australian firm Gadens. It is considering combining with Colombia's Cárdenas & Cárdenas, and Mexico's López Velarde, Heftye y Soria (LVHS).

Wragge Lawrence Graham & Co, the product of the merger between Wragge & Co and Lawrence Graham, will merge with Canadian legal giant Gowlings in January, creating a 1,400-lawyer firm in 18 offices in Canada, Europe, Asia and the Middle East.

However, transatlantic mergers present challenges in terms of structural and cultural synergy. Recent merger talks between Eversheds and Foley & Lardner did not result in a deal. This is surely a factor in the large number of US law firms with offices in London, which mostly focus on international litigation and arbitration, finance M&A, financial restructuring and insolvency. Around 80% of lawyers employed by US law firms in London are from the UK. (See charts on page 2)

UK national/regional firms are also expanding, broadening their geographical and sector coverage by opening new offices and merging – examples include the merger of Morgan Cole and Blake Laphorn to form Blake Morgan and CMS Cameron McKenna's acquisition of Dundas & Wilson. Irwin Mitchell has merged with Thomas Eggar, creating a £250m firm with more than 270 partners, and Addleshaw Goddard announced a merger deal with Scottish firm Maclay Murray & Spens. 2015 also saw distressed mergers, with Gordon Dadds buying Jeffrey Green Russell out of pre-pack administration, having taken over Davenport Lyons in 2014 after the administrators had been called in.

A key factor driving growth and merger activity, particularly in the UK's top 100 firms, is the internationalisation of the marketplace. According to research by *The Lawyer*, overseas revenue underpins the rapid growth of the top 100 UK firms in terms of revenue and lawyer numbers compared with the relatively slower growth in the lower half of the top 200. However, some firms' results were hit by foreign exchange fluctuations, including the weak euro.

Global Law Firms Ranked by Turnover

Firm	Lawyers	Turnover	Profit Margin 2015
DLA Piper	3,981	£1,504.9m	27%
Clifford Chance	2,992	£1,350m	33%
Allen & Overy	2,523	£1,281m	41%
Linklaters	2,601	£1,266.7m	45%
Freshfields Bruckhaus Deringer	2,322	£1,245m	46%
Norton Rose Fulbright	3,405	£1,118m	33%
Hogan Lovells	2,593	£1,079m	35%
Herbert Smith Freehills	2,294	£815m	32%
Dentons	2,744	£796m	Not provided
CMS	2,776	£753.3m	32%
Ashurst	1,633	£561m	35%
Squire Patton Boggs	1,356	£544m	15%
Slaughter and May	702	£504.5m	49%
Clyde & Co	1,270	£395m	30%
Eversheds	1,364	£380.7m	23%

Source: Legal Business

UK mid-market firms that seemed under pressure last year have, by and large, returned to profitability. According to a recent RBS report, firms ranked from 51 to 100 saw revenues rise by 13.6% in 2014/15 (although there have been some firm failures) and their trajectory seems promising, with some City firms' results outpacing the magic circle and biggest firms, which are slower to respond to changes in the market and the business environment.

Fee rates are improving after years of downward pressure as firms benefit from the uptick in real estate, corporate and litigation work. However, although most firms experienced revenue growth, there are challenges in converting this into increased profitability. Firms are focused on increasing efficiency and have been investing in outsourcing initiatives as well as moving support functions and less complex legal work to cost-effective regional centres. 2015 has also seen law firms offering tailored services to particular clients and markets. Examples of this are Olswang's equiP Programme which offers discounted and fixed-fee legal advice to UK technology entrepreneurs and start-ups. This follows the example of US firm Cooley, which opened a London office early in 2015 and in September launched Cooley GO, an online resource centre for technology start-ups and investors.

The liberalised UK legal market is dynamic compared with other jurisdictions because it allows alternative business structures (ABSs) that are not law firms to provide legal services. ABSs have seen winners and losers. The professional services' legal arms are doing well and expanding, and the high street is finding ways to compete with the volume service providers – particularly through online marketing and business development activities that highlight their local expertise and apps that personalise services by enabling clients to monitor progress of their matters via their smartphones. For example, they can check when a property sale has exchanged or completed.

Key Challenges

Managing change is always a key challenge for the legal sector. Peter Kalis, K&L Gates' Global Managing Partner, told The Lawyer Business Leadership Summit that women, machines and legal journalists were among the biggest agents of change for law firms. By this he meant the drive for diversity, the increased importance of technology, in particular the rise of automation, and more (and more critical) coverage of the legal sector. The business challenges, however, are around strategic management and decision-making in a dynamic competitive environment. Respondents to Crowe Clark Whitehill's benchmarking survey considered price competition in the marketplace the biggest challenge to their future success. In regional firms, this was closely followed by the availability of affordable, high-quality personnel.

As legal services become increasingly segmented – including international, City and regional law firms, volume and high-street ABSs, outsourced/managed legal services such as Riverview Law, and contract lawyers such as Axiom and Lawyers On Demand (LOD) – different elements of the market face specific challenges.

Non-UK law firms – Largest Offices in London in 2015

Firm by Number of Lawyers	London Fee Earners	English-qualified Lawyers	Other Qualified Lawyers
Baker & McKenzie	397	381	16
Reed Smith	373	365	8
White & Case	353	281	72
Latham & Watkins	296	178	118
Mayer Brown	251	249	2
Jones Day	217	201	16
Shearman & Sterling	166	106	60
Weil, Gotshal & Manges	160	153	7
Kirkland & Ellis	149	118	31
Dechert	139	103	36
K&L Gates	129	122	7
Skadden, Arps, Slate, Meagher & Flom	125	100	25
Cleary Gottlieb Steen & Hamilton	120	96	24
Sidley Austin	115	104	11
Debevoise & Plimpton	103	85	18

Source: Legal Business

Although the London market is particularly strong, with legal work driven by activities in the banking and financial services sector, the magic circle and big global firms face powerful competition from US firms with London offices. The US firms are gaining the upper hand. They are focused on profitability and it is almost impossible for foreign (UK) firms to penetrate the (US) legal market.

Corporate legal departments' focus on value for money means that magic circle and global firms are also facing competition for lucrative transactional work with national firms slightly further down the rankings. According to research by *Legal Business*, the most notable performances in the top 25 came from UK-focused firms that had experienced significant reverses in recent years – Pinsent Masons, Simmons & Simmons, Berwin Leighton Paisner and Addleshaw Goddard – which benefited from strong ties to London's financial services and the uptick in litigation work. The mid-market's ability to attract higher-value work is partly explained by competitive pricing, their agility and willingness to consider previously untapped markets, and the increase in numbers of fee-earning lawyers. Unsurprisingly, they consider the war for talent their biggest challenge.

Following market liberalisation, ABSs were seen as a challenge, both to high-street firms and other volume legal services providers. They also brought private equity (PE) money into legal services, and law firms are raising more money than ever before for expansion and investment in technology. However, ABSs do not represent a guaranteed return on investment, as was demonstrated recently when PE funder Duke Street wrote off its £30m investment in the Parabis Group – one of the first ABSs – which was subsequently placed into pre-pack administration, broken up and sold. A factor here is the reduced profit margins achieved by personal injury work due to the implementation of the Jackson reforms. Furthermore, Parabis included claimant and defendant firms.

But it is not all bad news for ABSs. Knights Professional Services, another early ABS, is in talks to acquire Darbys Solicitors. If the deal completes early 2016, it will create a £40m firm, pushing Knights into the top 100 UK law firms by revenue.

Professional service firms' legal arms are doing well, with their standardised, process-driven, fixed-costs strategy gaining them traction, particularly in emerging markets. Currently, they are effectively boutique practices that focus on legal services that complement their existing practices, such as compliance, due diligence, employment, immigration and tax. However, according to RBS, they are expanding and likely to compete with City law firms for lucrative transactional and capital markets work. There is also some innovation in the way they are run, with one professional services firm launching the first legal graduate training contract which replaces the requirement for a minimum number of UCAS points with online assessment. Accountants that secure ABS licences are also likely to compete with solicitors for probate work. Since October 2014 the Institute of Chartered Accountants in England and Wales has accredited 113 ABSs and a further 34 applications are being processed.

In 2015, commercial practice Gateley became the first UK law firm to carry out an initial public offering (IPO). Although Gateley has a healthy increase in pre-tax profits which increased 10.9% from £2.6m to £2.9m in the six months to 31 October – its first set of results since listing on AIM in June – research published by Thomson Reuters Legal revealed that the majority of law firms were reluctant to seek private equity funding or float on the stock exchange, preferring instead bank lending or alternative funding such as asset finance and invoice discounting.

2015, the anniversary of the Magna Carta, has also been a year of protest, particularly against the Government's legal aid cuts. Fees for duty solicitors to attend police stations and magistrates' courts fell by 8.75% on 1 July, despite a similar cut imposed last year and some lawyers are boycotting new legal aid cases paid at the lower rates. However, legal aid can also be perceived as a business opportunity. For example, McMillan Williams was the first high street firm to obtain external investment on the basis of its legal aid work, on the grounds that it balanced slim margins with the fact that government contracts are paid on time, so are good for cash flow.

Current Affairs

As the large corporates continue to expand their legal teams and reduce their panels, law firms, as their external advisers, are looking to establish closer alignment with their clients. Top-level moves in-house could help this. Lawyers are taking pivotal strategic roles in other businesses, for example, Linklaters' Managing Partner will join Lloyds Banking Group in January in the newly created role of chief people, legal and strategy officer. This role is above divisional heads, including general counsel Kate Cheetham.

Keeping up with clients' changing demands is a constant challenge – and opportunity. This includes leveraging technology such as mobility and online access via portals, extranets and, increasingly, apps. It is also about operational and cultural alignment between firms and their clients. For example, Vodafone is a paperless office with no landline phones – so looks to appoint tech-savvy law firms onto its panel. As the economy emerges from the recession, corporate legal departments are looking for value for their legal spend, rather than simply more for less.

Law firms and ABSs are compensating lower margins with efficiency measures, including automated processes and workflows, both client facing, where clients fill in online forms and matters are referred to the appropriate department and lawyer, and back-office, where automating routine processes boosts productivity. As the use of this type of technology has become widespread – and more affordable and user-friendly – it has become a necessary tool to compete effectively in the marketplace for volume legal services. Consequently, law firms are spending more than ever before on technology, with large firms' technology budgets running to seven figures.

The growth of artificial intelligence (AI) in legal, pioneered by ABSs like Riverview Law who in December 2015 launched Kim automated legal assistants, and innovative suppliers like RAVN who created an AI engine to complete routine due diligence work for Berwin Leighton Paisner, has shifted to mainstream legal technology with Thomson Reuters working with IBM Watson and LexisNexis acquiring Silicon Valley-based legal analytics business Lex Machina. There is also a sharper focus on in-house legal technology as Riverview and others offer their clients technology consulting services.

Diversity is another challenge which hit the news after Supreme Court justice Jonathan Sumption said positive discrimination in the judiciary would be a 'calamity'. The reaction has been a focus on diversity with many law firms introducing diversity targets and even quotas. These are focused on encouraging women into leadership roles and social mobility, with the introduction of legal apprenticeships shifting recruitment away from the public school/Oxbridge model.

The courts too are looking at modernisation, in terms of sharing information electronically to enable businesses to file cases and submit information online. Further changes are under way to enable cases to be handled faster and more efficiently. Developments in 2015 included the introduction of the Financial List, a cross-jurisdictional list to deal with high-value complex financial disputes.

Looking Ahead

Further liberalisation is on the horizon. In June, Justice Secretary Michael Gove pledged to conduct a review of the Legal Services Act within the current Parliament.

In November, the Government's Spending Review and Autumn Statement brought further cuts to the Ministry of Justice (MoJ), reducing its administrative budget by 50% within five years. It included plans to close 91 courts and use the savings to fund a £700m investment in technology designed to streamline and speed up the justice process. This will include the ability to hear more cases remotely, rather than in court. For example, bail hearings will be able to be heard via video conference.

The Chancellor also pledged to limit personal injury (PI) claims, removing the right to general damages for minor motor-accident injuries and increasing the threshold for small claims to £5,000. These changes are expected to come into force in October 2017.

Although they are likely to reduce motor insurance premiums, claimant groups and lawyers are concerned, particularly around whether the threshold should apply to all personal injury claims or just whiplash. Personal injury firm Slater & Gordon, which is listed on the Australian Securities Exchange (ASX), but generates about 40% of its revenue in the UK, saw its share price fall 52% overnight following the announcement. However, this has not stopped ABS start-up Pure Legal Limited from entering the PI market with the £13m acquisition of PI firm Pryors LLP.

Another consultation due to start early in 2016 includes making legal services regulators independent from their representative bodies and further lowering barriers to entry for non-legal businesses to offer legal services. The idea is to make it easier for estate agents and supermarkets to offer legal services such as conveyancing, probate and litigation. This is likely to impact ABSs and high-street firms rather than law firms that handle more sophisticated corporate and commercial work.

Leadership changes at several market-leading firms in 2015 indicate potential shifts in strategic direction at the top of the market and there is likely to be continued consolidation in the mid-markets. The pattern is that the larger global firms are consolidating, creating more global giants; the mid-markets are becoming more business focused, focusing on business agility to boost margins, while at other end of the scale, boutique and specialist firms and ABSs are focusing on delivering specialist services in particular niche areas. The maturity of the ABS model, notwithstanding some casualties, has created a more dynamic sector and it is likely that there are more changes to come.