

27 Jul 07

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THE LAWYER
30 JULY 2007

SPECIAL REPORT

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PARTNERSHIPS

Gemma Westacott, features editor

The flotation of Australian volume personal injury firm Slater & Gordon on the Australian Stock Exchange in May firmly placed the debate surrounding external investment and partnership structure reform back on most firms' agendas. Although the Legal Services Bill is still making its

way through Parliament, several firms have already thrown their proverbial hats into the ring. Halliwells, LG and Olschwang are just a few of the firms to have confirmed that they are considering flotations or private equity investment once regulations allow. In fact, research by *The Lawyer* has revealed that almost a

third of the firms in the UK 100 are in favour of allowing the injection of third-party capital. This Partnerships Special Report examines this trend, as well as the ongoing concern surrounding the requirement for firms to reveal the full extent of their pension deficits following conversion to LLP status.

Floating assets

Australian firm Slater & Gordon's flotation has thrown down the gauntlet for UK firms to follow suit.
By Chris Langridge



Although the Legal Services Bill is still years away from being in force, the mid-market is considering, or in some cases is preparing for, flotation (*The Lawyer*, 25 June). With Australian firm Slater & Gordon showing the way, a head of steam is building up.

Already the number of traditional partnership structures for solicitors is declining, with the number of incorporated practices tripling in the past five years. Most incorporated practices are LLPs, with relatively few opting for company status. Those that wish to raise external finance – and floating is one way of doing so – will generally fall into one of a number of discrete camps.

First, the mid-market, which may look for methods to expand domestically or internationally by purchasing a firm, either through debt or equity (or a combination of both). Second, those top 75-150 firms that wish to merge nationally to form an Eversheds or Shoemiths-type rival. Third, those that wish to incentivise existing and new staff. Fourth, those in the high street that, in the face of increased competition arising out of the Legal Services Bill, wish to merge to gain critical mass. And finally, those which already have streamlined offerings with high use of IT and a high proportion of non-qualified staff that present an easy target for new entrants.

Converting from LLPs

The fact that an LLP cannot float will mean that many LLPs, as well as traditional partnership firms, will convert to limited companies. The conversion itself should be relatively straightforward. Those practices that have converted to LLP status already will appreciate that it is not so much the legal work, as the logistics and administration of the changing, that takes the time. The conversion to LLP, if done correctly, would have been tax-neutral. The same cannot be achieved as easily for the conversion to a plc.

Profit in a company is taxed once with corporation tax and again in the hands of shareholders when there is a distribution. Some of this is mitigated by the tax advantages of a sale of shares and the availability of business asset taper relief: this values gross receipts at some 50 per cent higher as a capital receipt rather than partnership income. The other main consequence of incorporation is the impact of national insurance. This increases the total tax and national insurance (NI) burden from around 43 per cent to 54 per cent (although the true impact is nearer 50 per cent with tax relief on employer NI contributions).

Clearly a float could particularly benefit partners close to retirement if they cash in. Younger partners, however, may see this as their birthright being sold and see the burden of paying dividends as removing what would otherwise be their income. Nevertheless, a float

might benefit them by addressing historic pension or annuity issues, providing currency for acquisitions and retaining and attracting the best of the lateral hires. The profit might increase considerably, leading to a smaller share becoming a bigger number.

Blazing a trail

It is against this background that the flotation of Slater in Australia needs to be considered. Slater is essentially a personal injury (PI) practice. At the time it described its market as highly fragmented, but confirmed that it had around 10 per cent of the total national market. It had made five acquisitions over the previous two years, funded by debt, and had grown at more than 10 per cent compound since 2002.

Nevertheless, in any professional practice there will be key individuals. The prospectus discloses that "the departure of any one or more of the vendor shareholders would be likely to have an adverse effect on the company's operations". Nevertheless, there were no protective employment arrangements with these individuals, who could resign on notice, subject only to limited restrictive covenants.

No doubt the fact that the vendor shareholders retained a substantial shareholding (more than 60 per cent) was perceived by purchasers of shares to

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be a sufficient incentive to the vendor shareholders to remain in the practice and benefit from its further success. Their salaries alone – from AS225,000 (£96,400) to AS375,000 (£160,700) – would not have achieved this. The vendor shareholders did have to accept restrictions on their ability to dispose of their shares.

The particular strengths that were offered in the prospectus were the human capital, emphasising the alignment to core values as being a key feature; brand awareness of 60 per cent nationally (evidenced by the fact that clients came to the firm rather than to individual lawyers); strong referral contacts (major work sources were unions representing more than 250,000 members, other professionals and existing and former clients); a truly national practice; high-standard systems and processes; experience in project litigation (class actions); and a commitment to social justice.

In Queensland and South Australia incorporated practices were not allowed to have non-lawyer shareholders and sharing fees with

non-lawyers was prohibited. To avoid these problems the senior partner operated offices in these states as a sole practitioner, with the company providing premises, equipment, non-lawyer employees and IP rights, including the right to use the firm's name. In return the senior partner paid service and licence fees to the company. This might be a model that could be adopted in England and Wales now. Succession in the event of the senior partner's death or retirement would need to be assured.

Financial implications

Slater raised AS35m (£15m) and the funds were destined for the vendor shareholders (50 per cent), costs (6.5 per cent) and reduction of debt facilities (43.5 per cent). The replenished debt facilities were then to be used to acquire further, apparently as yet unidentified, practices.

On the face of it, this does not make an attractive offering. The growth prospects, said to be consequent on legislative changes, depended heavily on acquisitions that were not identified, so consolidation in the marketplace, while a laudable aim, was unspecific and dependent on trusting a track record that was both recent and modest. The additional aim of national brand-building seemed optimistic given that there was an existing 60 per cent brand awareness. How many lawyers could do better than this?

A dividend policy of 40-50 per cent net profit after tax was declared, equating to a forecast of a 4 per cent return. A price/earnings (P/E) ratio of 12.5 was achieved at close on the first day of trading. This is consistent with the UK market pundits' general perception of the P/E achievable by law firms and reflects Tenon Group's acquisition of the niche law firm Statham Gill at a reported P/E of around 16.

These figures are likely to be more typical for most firms than the current 4.55 per cent yield and P/E of 25 for accountants Tenon, the 1.98 per cent yield and P/E of 36 for accountants Vantis, and the 0.82 per cent yield and staggering P/E of 43 for accountants Begbies Traynor (albeit this is up from around 12 in 2004).

Slater's current share price is around AS1.60-AS1.70 (69p-73p). With brand values, according to the survey by Intangible Business, of more than £1.8bn for Linklaters and £480m for Eversheds, the attraction of an IPO cannot be underestimated.

It has been done Down Under, so how long before we see the first listed UK law firm?

As an alternative to floating, many firms may prefer to have off specific practice areas, such as bulk PI, conveyancing or will production, into limited companies and then develop them under standalone brands before selling to others who are on the acquisition trail. ■

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