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An end to the M&A boom?

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(https://www.legalfutures.co.uk/wp-content/uploads/Jeff-Zindani.jpg) [2]

Zindani: Some firms woefully unprepared to weather the economic storm

Last year saw a steady stream of law firm mergers and acquisitions but, in 2023, with economic storm clouds gathering, the M&A landscape is likely to change considerably.

So what does the future hold? Post-Covid, there was a sustained increase in M&A deals across the legal sector, from global mergers such as Clyde & Co and BLM, to consolidators like Knights snapping up regional firms.

This was driven primarily by the recognition amongst law firm management that, if they wanted to grow apace, they needed to make acquisitions – organic growth alone was not enough. Acquisitive firms were also fuelled by cheap money and, more recently, by the talent war which has seen competition to attract and retain the brightest and best lawyers reach new heights.

But the legal sector is not immune to the economic volatility we are currently experiencing. Last autumn, there was a sudden spike (https://www.legalfutures.co.uk/latest-news/sra-sudden-spike-in-number-of-law-firms-facing-financial-difficulties) [3] in the number of law firms of all sizes reporting to the Solicitors Regulation Authority (SRA) that they were facing financial difficulties.

The SRA suggested reasons for the increase included the need to repay the government's Covid support, deferred tax bills and rises in professional indemnity insurance costs.

The unexpected collapse of the large law firm consolidator Metamorph is another early sign of trouble ahead for the high-volume, low-margin firms. It appears many firms are already struggling and will be exposed in the downturn.

It is inevitable that this will have repercussions for M&A activity in the coming months. Law firm leaders we have been speaking to are already wondering whether what is currently a sellers' market be replaced by a buyers' market, or at least whether some equilibrium will be restored.

Winners and losers

A halt to all M&A activity as the result of the downturn is unlikely. Instead, we are more likely to see a shift in activity that will vary sector by sector. There will be both winners and losers.

Certain practices will still be 'hot'. This will include the obvious recession-proof practices such as personal injury and clinical negligence, which will continue to see demand regardless of the economic outlook.

Growth areas such as family, private client and employment law will, we anticipate, continue to thrive. We also see real resilience and perhaps modest growth in insurance services and, of course, insolvency and litigation.

Firms operating in these areas will increasingly be targeted for acquisition or be in a strong position to bolt on new teams and practices.

For those eyeing strategic acquisitions, boutique commercial and private client firms still remain top of their wish list. Some managing partners we speak to have rather more unusual requests that fit in with their specific requirements, ranging from requests for Court of Protection specialists to financial services firms.

As one private equity house remarked, the legal sector has some "eternally profitable businesses that are perfect investment platforms". It certainly does not appear to be time for them to stop buying.

The losers will inevitably be those most exposed to soaring interest rates and the considerable squeeze on consumers. Conveyancing businesses and other related property practices that until recently were boom areas will suffer, particularly if we witness a house price crash.

Fortune favours the brave (but only if there's available cash)

As some less resilient businesses see revenues begin to decrease and overheads rise, the pressure to merge may well become impossible to avoid. A report published by chartered accountants, Hazlewoods last year suggested that, while partners had been happy to sit tight as the profits rolled in over recent years, many were beginning to feel the strain and likely to decide it's time to sell up.

There will be firms woefully unprepared to weather the economic storm – unfortunately, some partners only seek change when it is too late and the pain is already being felt. Management guru Peter Drucker was right when he said that "the organisations likely to suffer the most are those with the delusion that tomorrow will be like yesterday".

As some firms inevitably begin to see a merger – or, more accurately, acquisition – as the only way out of financial distress, opportunities will be created for those looking to acquire. They will need to make crucial judgements about whether these firms are rich pickings or risky liabilities.

That means looking beyond the financials, which, from experience, are often wrong. Buyers who focus simply on making the sums add up can encounter serious issues post-merger.

A recent Deloitte report (https://www2.deloitte.com/content/dam/Deloitte/us/Documents/mergers-acqisitions/us-ma-consulting-cultural-issues-in-ma-010710.pdf) [4] found that culture was the cause of 30% of failed integrations. Acquirers need to do in-depth cultural due diligence to guard against choosing the wrong merger partner and have a clear shared vision of what a post-merger strategy looks like.

Opportunities: a buyers' market?

It is easy to see how a downturn could pave the way for a true buyers' market, particularly when so many potential acquirers have a large amount of cash on their balance sheets. Added to this, despite the doom and gloom, there is still funding and external investment available for the right deal, including from private equity firms who are ready with money to invest.

Seeing potentially rich pickings, they are unlikely to be deterred by a recession.

This is where we see profound difference between today's market and the 2008 recession. This time around, there is still an enormous amount of deployable private capital, including buyout, venture capital funding, and funding from other investors in the wider global economy. Available investment is at its highest level in history at $3.6trn – three times the figure in 2008.

This presents a real opportunity for savvy firms to achieve growth despite the prevailing economic winds. The downturn offers the chance to acquire or merge with firms that fit into a more long-term strategic vision, potentially making long sought-after firms a more realistic target than they might otherwise been.

As futurist Joel A Barker put it, "a vision without action is merely a dream". Past experience suggests that potential acquirers should be gearing up to make deals.

Paul Romer, a Stanford economist, once said that "a crisis is a terrible thing to waste". There is solid evidence from the 2008 global financial crisis showing that companies that made significant acquisitions during the economic downturn outperformed those that did not.

When the going gets tough

How about recruitment? Will the sector see a continuation of this chase for talented professionals? Or will it slow to a halt as the going gets tough? The answer is, of course, well known to fans of Mr B Ocean, that the tough get going.

There will always be room to add new hires where there is a solid business case, the firm has the bandwidth to do so, and the culture is appealing enough to entice them to join from somewhere else. In some cases, this could mean looking at the option of rolling out the red carpet to lawyers on a fee-sharing basis.

Adding to a firm's talent pool via discreet channels to plug the gaps in those lucrative service offerings is always a good call, a tactical play alongside the strategic drive to grow through acquisition.

The coming year will be a tough time for the country and for many legal businesses, with much uncertainty. For firms that find themselves in financial difficulties there will be hard decisions to make.

For those in a strong position as the downturn hits, a bold strategy around well executed acquisitions and selective new hires could allow those firms to steal a march on the competition.