

A Review of the Financial Year – 2008-2009

At the close of this financial year we reflect on what has been an exasperating period for many businesses. Economic instability has shaken the tables of many boards. Management teams have been faced with difficult decisions around direction and cost cutting. A lot of which has involved cutting your most important asset – your people. We can not say who has made the best move or made the right decisions. The truth is this recession has brought about problems which have not been seen before.

Turnover in the legal sector declined 7.3% in the first quarter of 2009 compared to the first quarter of 2008. But whilst the drop in business levels has reduced work in certain areas many legal firms have stepped up and grasped the opportunities that the economic position has presented.

Strong businesses with diversified practice areas have been able to maintain turnover even when demand is falling in certain areas. Litigation, Insolvency, Employment, Restructuring and Insurance have all benefited from the recession. Dispute Resolution, Infrastructure and Technology, Media and Telecoms have also held up fairly well. Businesses with a strong focus in these areas and a quality service offering with high calibre people have managed to grow.

It is important to remember that the industries previous three years of double digit growth was fuelled by robust global and UK economic growth; record global mergers and acquisitions; and high levels of activity in the financial and commercial markets, all of which have rapidly reversed. This has had significant negative impact on firms with large exposure to the Property, Corporate and Financial Services sectors, as well as businesses that rely heavily on M&A and high volume transactions. For the smaller firms, the drop in volumes affects them much more, as many have historically supplemented legal fees with the value of client balances which have fallen in both quantity and return in the low interest environment.

Over the last 15 years UK legal firms have expanded their reach into new waters across the globe. In the boom time, some saw this as a costly operation, with the overseas offices draining profits. However now, some may say those with a global reach are better equipped to defy the downturn. The global elite have benefited from the rise of Asia and other emerging markets. In fact, it is believed that the emerging markets make up 15 – 20% of revenues in some companies. We are seeing more and more firms announcing their focus on the rising dragon, in particular, China, Hong Kong and Singapore.

Any firm with global activity and money coming in from abroad will no doubt have had to sit up and consider the implications of the 30% moves we have seen over the last six to eight months in the Sterling Dollar and Sterling Euro. Whilst some businesses may have suffered from the weaker pound, firms with work in the US and Europe billing in local currency have benefited profusely. With the strong currency effect, non-sterling income has boosted profit and revenues to counteract the fall in fee income. A word of caution though, currency moves of this extremity may not be repeated in the current year where we have already seen Sterling strengthen against the Dollar. We recommend you speak to your bank if you are concerned about your currency exposure as they may be able to offer you strategies for protection.

From the financial results announced to date, we can see that the majority of businesses which have managed to maintain turnover have seen a dip in profits. This comes as no surprise as profitability of the top 100 law firms has been slowing over the last three financial years and in this financial climate it was inevitable. This steady decline in profitability has taught the largest players to cut their cloth accordingly and they have now become very well accustomed at doing so. Even so, this year virtually all firms have had to make both fee earners and support staff redundant, freeze pay, introduce mandatory sabbaticals or reduce working weeks, all in an attempt to reduce their biggest cost. There has not been a day gone by that people issues have avoided the headlines. This year despite the copious cost cutting, profits have suffered severely, with some firms announcing 30% drops in PEP. The results at the close of this financial year include the cost of the redundancies made and it will not be until next year that we will have a clearer picture of the benefits.

Also affecting the bottom line this year is the collapse in interest rates. These historic lows come with two sides to the coin. Whilst it has reduced borrowing costs, firms have seen their returns disappear on the balances held on behalf of their clients and those with commercial mortgages have found themselves locked onto relatively high interest rates. Consensus forecasts expect interest rates to remain at the current level throughout 2009 and only gradually increase next year. Although, some recent readings of the yield curve suggest that the market is now expecting rates to increase at a brisk pace in the latter part of 2010.

As ever, cash prevails to be king. Maintaining sufficient cash in the business has proved harder for law firms in the last year as their pressures on cash flow increase. Clients are taking longer to pay as law firms are often seen as an easier creditor to delay than other expenses such as utilities, rent or staff. Whilst firms are improving in their attempts to collect cash, lock up continues to worsen. The cash drain is exacerbated as firms are paying distributions and tax based on the previous year's performance which in most cases was significantly better than the current year.

As a result, firms are having to make greater use of their borrowing facilities. The concern of having enough cash coupled with the general concern of the credit markets has prompted many firms to raise partner capital and request higher credit lines from their bank, even if it has been to the detriment of higher margins and fees. We are seeing a greater demand for businesses to seek to replace on demand facilities with committed facilities to provide greater comfort. This has been easier for firms that have their borrowing facilities correctly structured and for those who maintain an honest open relationship with their bank. Liquidity problems have been one of the biggest challenges for the survival of firms in the SME market. Interestingly, for those businesses, a lack of cash causing late payments has been a greater problem than the lack of demand. This is an issue which could be avoided with the appropriate management information and monitoring allowing firms to identify problems before they arise.

As we begin to review the budgets for the new financial year we can see that the majority of firms are expecting the second half of 2009 to be worse than the second half of 2008. Many are predicting little or no growth with a modest reduction in fee income. There is hope that profitability levels will rise from the heavy overhead

reductions made this year. Prudent financial planning is in place in preparation for the unknown.

Having not changed much for the last hundred years, interesting times lay ahead for the legal market. Change is amongst us and many firms are embracing it positively. The firms best able to adapt will be the most successful. Law firms are already becoming more commercially managed and they will continue to develop as a business. The sector will most likely pick up pace as it is fuelled by external capital and new ownership structures. Consolidation is expected as smaller firms restructure and merge, and some firms within the top 100 may start to use capital from external shareholders to buy firms with a complementing footprint. We don't expect the change in management structures to significantly alter the way the large scale international firms operate. However, we anticipate them becoming more innovative with their commercial offering which may be a result of the firms merging with other services.

Consensus forecasts predict that the market will continue to contract through the rest of 2009 and in 2010 the economy will begin to show signs of recovery at an expected growth rate of 0.7%. In 2011, growth is expected to return to a more normal level in line with the long term trend of 2.5%. Economists predict the US and Europe to remain large legal markets as Asia grows and contributes generously. As the economy recovers, globalisation will continue to underpin strategies of the largest players. The new world will witness brand become increasingly more important. Trusted global firms will slowly embed their roots into new pastures across the world. Having an aspirational brand will propel the silver circle firms into aggressive growth.

The next twelve months are likely to remain challenging for firms and this will undoubtedly present opportunities for those that are well run, well capitalised and well funded.

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