

The Long Term Impact of Incorporation on the Australian Legal Industry

A Structural Analysis

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Legislation across Australia to enable legal partnerships to incorporate has been a long time coming but is on the near horizon with NSW and Victoria active for a few years and now Queensland with its state legislation in place from 1 July 2007 under the *Legal Profession Act 2007* with other states following.

The implications for the structure of the industry are far and wide. Much attention has been focussed on the operation of multidisciplinary practices and of late the option for firms to float but the impact is much wider than that. Incorporation may well change the competitive structure of the industry over the next 5-10 years.

Critical to the whole change is the fundamental difference that legal service providers will have the ability to share profits with others and therefore will have access to capital. Lawyers will no longer be constrained (or protected) by the partnership model where all funding has to be provided by the partners and all profits have to be distributed fully to them, leaving no retained earnings in the business nor the ability to share profits with other parties.

Australia's law firms are facing challenges - how to continue to grow in a mature market, provide excellent client service and retain/develop talent with increasing pressure on knowledge sharing, ensure efficiencies in service delivery and find ways to export their expertise and skills into relevant markets overseas.

Some argue however, that none of these challenges will be resolved by an influx of capital and by bringing in outside shareholders. The objective is to form a "virtuous circle" whereby having the best people attracts the best work in the market and the very best clients. This leads to the professionals being highly utilised on meaningful work, which drives high motivation and high profits. The high performance of the firm then leads to its ability to attract and retain the best people. Counter to this is that the industry, whilst by no means being capital intensive, does require an impetus to restructure and become more efficient. Capital is currently locked in individual's beneficiary accounts which either require new entrants to pay exiting incumbents or for them to be paid out as part of the annual distribution of profits; few firms can achieve 100% distribution. Hence capital is now used within the business for future development and most capital expenditure spending is funded by debt finance.

An analysis using the Structure Conduct Performance model is shown below:

- Structure being the way the industry is set up
- Conduct being the way the industry as a whole in most part behaves
- Performance being the outcomes /results from the industry

This type of analysis demonstrates the possible impacts on industry competitiveness and outcomes for industry players. Structural change at an industry level can have a significant impact on participants especially for those who have not examined or positioned themselves to take advantage of the imminent changes.



| Structure | Conduct | Performance |
|---|---|--|
| Current – Partnership Model | | |
| Highly fragmented - only ~25 firms revenue >\$40m and 12 >\$100m in a multi billion \$ industry | <p>Many SME type operations commanding small very localised market share</p> <p>Conglomerates of small pseudo-business units or practice groups based around individuals</p> <p>Limited successful cross marketing within mid and large firms; silo mentality</p> <p>Business security dependent on relationships of individuals with clients</p> | <p>Strong returns to equity partners at the mid – large firms with average returns for the majority of smaller ‘suburban’ firms</p> <p>Stronger results for specialist, niche players</p> |
| <p>Low barriers to entry</p> <p>§ Unrestricted practicing certificate</p> <p>§ Relatively low capital investment required</p> | <p>Individuals in smaller practices enjoy control of and influence over their own business and collegiality with like minded individuals</p> <p>Significant interchange of personnel; business moving with individuals</p> <p>Access to development capital restricted to the partners financial capacity</p> | <p>Practitioners able to enjoy reasonable returns for personal effort</p> <p>Lack of economies of scale – investment lagging</p> <p>Significant movement of business with personnel transfers especially senior partners</p> |
| Succession | Succession issues for many firms with lack of ability of senior partners to extract their built up goodwill | <p>Succession typically handled in ad hoc manner and leading to significant business development and continuity issues</p> <p>Cyclical results over the long term dependant upon resources and succession</p> |
| Competitive industry with supply greater than demand – clients generally have choice of lawyer/firm to engage | <p>Significant spend on building relationships – highly competitive environment</p> <p>Industry expectations including pricing methods and levels well established for expertise with discounts limited to some sectors of work type and volume work</p> | Limited visibility of viability but returns protected by the historical expectations of participants for most sectors |
| Firms in ‘branding’ alliances | <p>National arrangements typically brand related and limited back office support (i.e. not fully integrated single national business.)</p> <p>State or regionally based firms with common branding but financially independent</p> <p>Limited integration and low barrier to disbanding alliances</p> | <p>Appearance of national practices but underlying tensions between interstate offices especially with respect to rewards</p> <p>Limited extraction of economies of scale – some in marketing, IT but not as effective as if a single corporation</p> <p>Alliances commonly forming and reorganising</p> |
| Highly regulated – including self regulation by Law Societies in each State | <p>High quality of work across the profession</p> <p>Industry standards maintained</p> | <p>Duty to courts paramount and high standards maintained</p> <p>Professionalism strong</p> |



| Structure | Conduct | Performance |
|---|--|--|
| Future – Partnership Model | | |
| Remaining highly fragmented with individuals or small numbers of equity participants retaining control | No major change - individuals with strong personal relationships will continue to command work Succession issues will continue Limited transparency of operations or results | Smaller less efficient partnerships gradually squeezed with reducing margins and less attractive propositions Specialist firms still able to command above market returns Some partnerships will remain in tact until current regime retire, withdraw or go broke |
| Future – Corporations Model | | |
| Capital funds will enable the industry to consolidate with many smaller firms being bought out/ merged Larger number of firms in \$20-100+m size range | Increased focus on branding and corporate reputation Capital expenditure to achieve efficiency via consolidation, technology investment Increased commercialisation including professionalism in management of smaller firms, increased business development, marketing including advertising spend Increased number of truly national businesses Management practices and commercial drivers will override the wants and needs of individuals/owners/shareholders and participants in the business Some firms may become public companies by listing on a stock exchange Introduction of different functional structures with true accountability | Increased organic growth due to increased visibility of reputation, brand strength and positioning (examples being top consulting firms) reliance on brand reputation to command work Mergers and acquisitions increase significantly; market consolidation Market returns gradually reducing via competition towards typical market returns of professional services companies but with larger more efficient firms continuing to produce above market returns Improved accountability and focus on business rather than individualistic drivers; differentiations of roles owners/employees Commercial management practices including quality assurance will be an increasingly important differentiator |
| Increased consolidation of more general practices – groups including franchised operations | Limited MDP where alignment is operationally efficient e.g. real estate firms with legal arms; Insurance companies with legal claims teams MDP characterised by a volume of regular transactions which are process driven; likely to exclude complex litigation | Supply/demand imbalance will slowly be redressed at mid-large end of market |
| National firms will become stronger | National organisations will be truly national and take advantage of economies of scale with increased investment in marketing, IT infrastructure and HRM but particularly knowledge management | Increased penetration into national clients with growth in market share and protection of margins Increased niche opportunities for regionally based firms |



| Structure | Conduct | Performance |
|---|---|---|
| Larger organisations setting up their own legal arm and specialists becoming law firms | Other organisations entering the legal market Examples of increased competition - Major banks setting up in-house law firms; employer organisations/advocates becoming legal firms | Increased competition will impact returns – lower usage of outsourced providers Larger firms will seek to align drivers and reduce costs by acting as an internal law firm for their organisation {example being major bank setting up an internal marketing agency} Specialist work will still be briefed out at increased fee rates |
| Highly regulated – including self regulation by Law Society and increasing via Corporations law | High quality of work across the profession Law Societies will have to become more aligned if not national in nature | Professional standing with respect to the Courts will be maintained |
| Succession issues more readily resolved | Ownership will be more readily separated from day to day performance via shareholding with ease of facilitating changes Shareholding will evolve to more participants even with a small shareholding | Increased 'liquidity' of ownership – more diverse ownership Equity partnership no longer being the 'end-game' Share ownership used as a positive reinforcement and alignment of business outcomes and employees' objectives |
| Corporate governance | Increased governance processes especially for mid sized partnerships would be required Initial tensions between obligations to the Courts and obligations to shareholders Increased transparency in business outcomes | Improved governance within the corporate regulation framework Long term obligations to the Courts resolved as core to long term business success |

Consolidation of the Legal Industry to Occur

Industry consolidation can occur when macro economic impediments or externalities (such as regulation) change, then market forces such as competition will drive efficiencies and the industry structure will change. Evidence from other like industries is both instructive and compelling. Examples include the medical industry with the establishment of commercially run general medical practices, the engineering services profession with companies taking over smaller partnerships and consolidating them to achieve economies of scale and economies of scope through integrated marketing opportunities. These changes have all been driven by access to capital, indeed such changes could have occurred previously but were delayed and in some cases prevented by lack of capital.

Competitors will expand

The competitive environment at a macro industry level will change with incorporation and with the increased number of more commercially focussed organisations {focus on shareholder wealth creation} operating in the industry. New entrants into the market will emerge and existing competitors will develop especially as access to capital accelerates industry consolidation with business at the smaller end of the market being ripe for consolidation. Even if the percentage of practices that incorporate is relatively small the impact will still be significant. Whilst the historical roots, the inherent conservativeness of the profession and the fiercely independent nature of equity partners will all slow the changes, they will not stop them.

New Entrants including Multi-disciplinary practices

Incorporation will enable affiliated business to come under a 'one stop shop' and provide services across markets such as real estate and conveyancing or insurance claims handling and litigation. This will carry through to areas such as workplace relations where organisations such as industry or employer associations and unions will be able to provide legal advice through their own incorporated legal practice. Financial planners would also be able to consider providing the legal aspects of wills and estate planning.

Some markets that have traditionally been the domain of lawyers in private practice will face significant changes probably more quickly than other sectors. Areas such as conveyancing, estate management and claims handling will be open to another level of competition and this could remove some baseline business revenue which will force smaller businesses to restructure to survive.

Stock Market Listing of Incorporated Legal Firms

It is clear that the access to capital and the ability to share profits with other parties will enable the industry to consolidate and become structurally more streamlined. Incorporation may also lead to a further step of a legal firm listing and becoming a public company. Integrated Legal Holdings (ILH), DJC Lawyers and Slater & Gordon - each using slightly different business models - have announced plans to go to the market to raise capital to fund future growth and expansion. Slater & Gordon successfully floated in May 2007 and have already announced their first acquisition.



Essentially, there are three reasons an organisation may choose to list.

1. It can enable them to acquire the capital needed to fund a change in business direction for example diversify into a multidisciplinary practice which includes other related businesses
2. Listing can provide funds for acquisition – pursuit of growth and industry consolidation
3. There's the "get-rich-quick" motivation, where current owners prosper from a listing and can exit – liberation of capital

Opportunities for future expansion via private equity investors or ultimately by initial public offer (IPO) can be anticipated, but will be accompanied by increased competitive pressure from areas such as changes to pricing structures and commercial arrangements particularly with large purchasers of legal services. Incorporation will enable legal practices of mid to large size to compete with these activities more readily.

External shareholders alone, such as in an IPO, may not bring any additional required skills and having to share profits with external shareholders may simply reduce the incomes of the people who deliver service to clients. However incorporation provides an entry for the required skills to drive the business and manage the capital flows. Selection of Directors for Board representation including Chairman of the Board will be paramount to drive these businesses as with any other commercial operation and can provide much needed corporate competencies to assist such organisations.

Building relationships, delivering effective legal services, growing in relevant markets, building economies-of-scale and selling cross-jurisdictional services are the best ways to meet the challenges facing law firms all over the world. Key here in making the industry more efficient is access to economies of scale which is facilitated by incorporation primarily with private equity and ultimately public shareholding funding that drives the industry to consolidate and realise latent efficiencies.