Saffery Champness
CHARTERED ACCOUNTANTS

Merger and acquisition activity in professional practices firms

The appetite for growth and need to consolidate in 2022 and beyond

June 2021

Introduction

The past year has been a hugely disruptive period for businesses. The impact of the Coronavirus pandemic has been felt across all sectors and, while there have been casualties, there have been some clear success stories, with some firms reporting record profits.

Over the course of 2020 and early 2021, Saffery Champness produced a number of reports that considered the impact of the pandemic on professional practices as the situation evolved. There were clear challenges being faced across the sector but, as we all came to accept (if not entirely understand) the situation, the dominant mood across the professional practices landscape became one of cautious optimism.

From our reports we found a number of themes emerging, including the use of furlough (and potential repayment as conditions improved), revised budgets were exceeded and firms were able to accelerate their agile working policies.

Coming into 2021, some of our predictions around the use of office space in our 2020 report, 'The End of the Office?', are starting to develop, as firms consider what the core use of an office should be.

As we come out of the depths of the pandemic, we asked professional practices from various sectors, and of various sizes, a number of questions to understand appetite around M&A and the key challenges they foresee in growing their practice in 2021 and into 2022.

We were joined by two external contributors, David Sparkes, CEO at Millbourn Ross and Anne Harnetty, Managing Director and Founder of Jonson Beaumont respectively.

David provides his expert insights on M&A in the professional practices environment, and Anne is able to provide her views on one of the key messages coming through in this report - people. Recruiting, developing and retaining good people continues to be the key challenge for respondents.

We hope you find the results of value to you in running your business, and, as ever, if you would like to discuss any aspects of this report please do get in touch.

Jamie Lane, Partner and Head of Professional Practices Group
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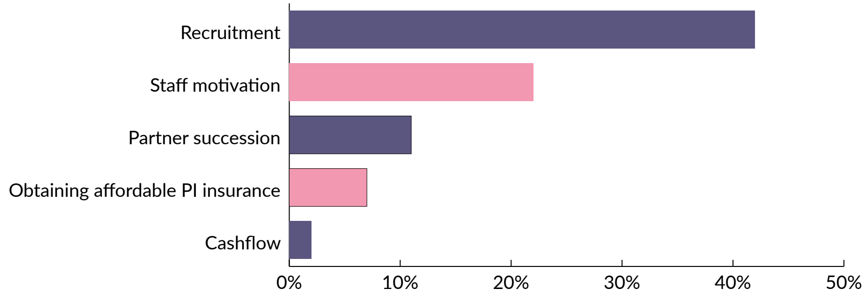
The mood in the market – what is on the minds of firms?

We asked our respondents for their view on the single biggest operational challenge over the past 12 months.

Fig 1: Other than the immediate operational challenges posed by Covid-19, which of the following factors has been the biggest challenge to your firm over the past 12 months?



Clearly, the single biggest factor on the mind of firms is recruitment and that comes as no surprise. If you were to look at any commercial survey released over the past few years, staffing issues sit at the top of most firms' minds and it is important to note that this is not just the availability of staff – it is no secret that candidates in the professional sector far outnumber available positions – but it is the availability of good quality staff that poses the biggest challenge.

For firms that are willing to put the necessary time into a well-structured, strategically led recruitment campaign, they will want to know that their new hires are willing to stay and contribute to the success of the firm.

And so it is no surprise that our result show that the second and third most important factors were also people focused. Almost a quarter of firms see staff motivation as a critical challenge, with a large proportion looking further ahead to the thorny issue of partner succession.

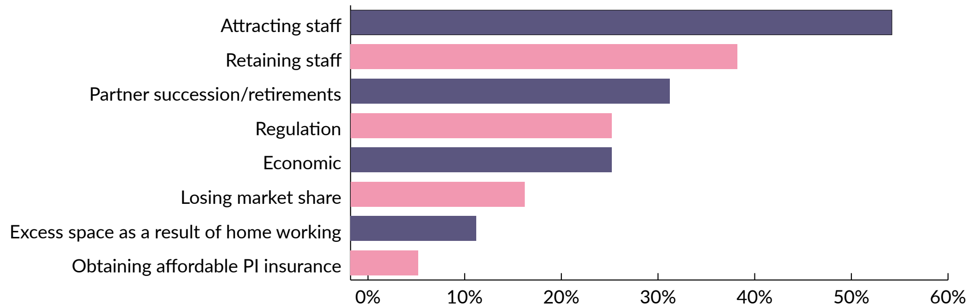
In a hardening market, it was a little surprising to see only a small proportion of firms viewing affordable PI insurance as a big challenge, though this is very much dependent on the timing of renewals.

An even smaller proportion put cashflow at the top of the list. 12 months ago, cash was a massive area of concern for all firms as we moved into the pandemic. However, the availability of government support schemes for all types of practice has meant that conditions may not have been as difficult as many predicted, and we have seen large numbers of firms creating a cash 'war chest' to help them overcome future disruptions.

As we will see later in this report, financial issues actually play a relatively small role in firms' overall M&A strategies.

Looking ahead, we asked firms to dust off their crystal balls and give their thoughts on what the challenges over the next 12 months will look like.

Fig 2: What do you see as being the primary threats to your firm's future over the next 12 months? *(participants could select multiple options)*



Again, we saw staff-related matters sitting at the front of firm's minds – attracting and retaining staff will be driving most firms' growth strategies for the foreseeable future.

We also saw that partner succession issues are a much more prominent factor and with that in mind, we wanted to build a clearer picture around how succession is managed in firms and understand to what extent succession follows a well mapped out route, or whether it generally follows a more 'dynamic' approach.

Anne Harnetty, Managing Director and Founder of Jonson Beaumont:

"This research into firms who have been through the M&A process shows that often there is no clear merger strategy, and no longer-term purpose and vision of what objectives need to be met if a merger takes place. M&A needs robust planning, due diligence, and in-depth analysis. Frequently there is a reliance on merging with firms where partners have a connection and are in a similar location. The strategy becomes a desire to merge rather than a thorough plan with a desired outcome that has tangible benefits to both firms. There is an assumption that because people know one another, issues such as PII claims can be taken at face value, our research showed that this is an error partners would not repeat. Evidence showed a case where the claim was misrepresented but they knew one another and believed that they shared cultural values it was accepted. It took the merged entities three years to recover the significant cost, which had a direct impact on partners drawings.

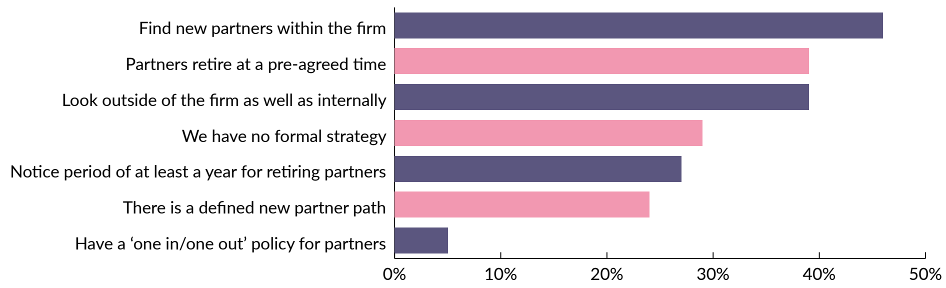
"Culture is always stated to be the biggest priority, yet most firms do not know what their culture is, but they all say it is collegiate. Merging firms must identify what makes their culture distinctive. What is it that partners value in that culture, how do staff connect to it and how will it benefit clients? The new vision for the merged entity will likely find a change in culture. For people to embrace that culture you must ensure that you help them share the vision of what you want it to be.

"Central cost efficiencies are important after a merger but there are significant integration costs which must be considered with a clear financial plan. Fully cost IT systems, with a project leader who will look at this for the best solution for the merged entity rather than be territorial about systems. A larger merged entity often needs higher level operation staff heads who cannot be attracted or retained at the same cost. It is easy to believe that you can do everything yourself, but a merger broker and a project integration leader add value. M&A integration is exhausting, can you really continue doing business as usual, bill, resolve day-to-day issues and find the hours needed for a successful merger?"

www.jonsonbeaumont.co.uk

Succession planning

Fig 3: How is succession managed in your firm? *(participants could select multiple options)*



Surprisingly, very few firms seem to adopt a 'one in, one out' policy for partners.

While a lack of restrictions on partner retirements can allow for greater flexibility, firms must always make sure that partner succession is viewed as a long-term project, where managing the firm's working capital requirements needs to be carefully balanced against outgoing partners' expectations of withdrawing their capital or realising their investment. While most partnership agreements will have some sort of provision to limit the number of partner retirements over a certain period of time, it is not clear to what extent such a policy would be enforceable, or practical.

Furthermore, while a 12-month notice period might appear to be ample time to arrange a seamless succession for partners, the reality can be much more complicated – especially where a firm is targeting people from outside the firm, as they will have their own notice periods to deal with. Just over 25% of respondents have a notice period of one year or more for retiring partners and so it is vitally important for firms to ensure that their succession management strategy is not just formalised, preferably with some form of buy-in from current and future business leaders, but that it is also periodically reviewed to make sure it is fit for purpose.

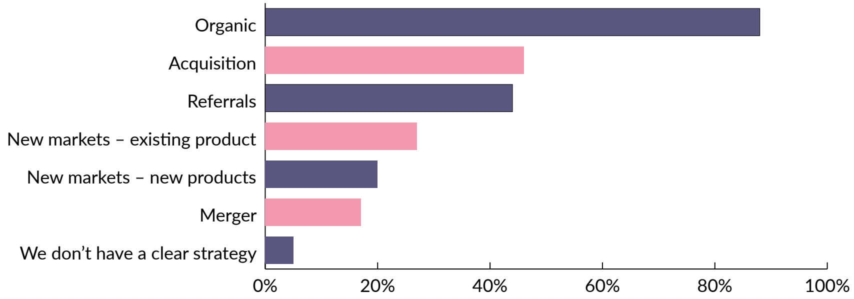
With that in mind, it is encouraging to see that the majority of firms appear to have some degree of formality, though almost one third of firms have no formal strategy in place.

Where does this leave firms' plans around M&A?

So far, we have learned that people play a large part in firms' strategies for success, and invariably, a long-term strategy that centres on people development will feed a successful succession pipeline.

We now look at firms' views around growth strategies, and in particular their M&A strategy.

Fig 4: Which of the following most closely drives your growth strategy? *(participants could select multiple options)*



Growth is almost universally seen as an organic process – almost 90% of firms cite this as a factor that drives their success, but growth is not necessarily achieved by following just one strategy.

Over 60 %

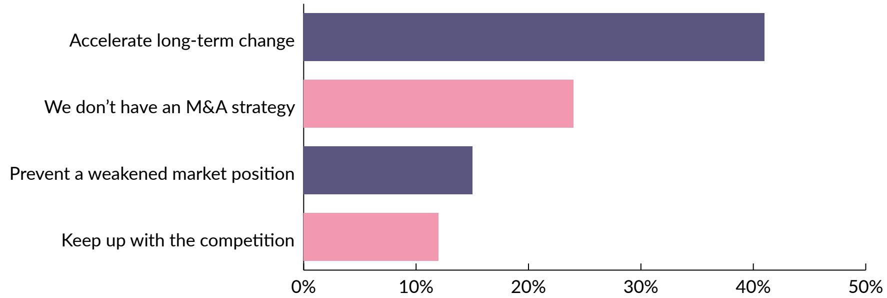
of firms see mergers and acquisitions as key drivers to growth

Over 60% of respondents see mergers and, to a larger extent, acquisition, as being key drivers to growth, and we will explore this in more depth a little later, but growing the firm through entry into new markets plays a big part too. Around 20% of firms appear to be considering growth through entry into new markets and it is possible that this is being fuelled by recent changes to working practices. As firms have been forced to explore how they deliver their services, there has also been questions around what those services actually are.

For some firms, this question around what their service line will look like in the future has invariably influenced their appetite for acquisition and merger, and that is a theme we will explore next .

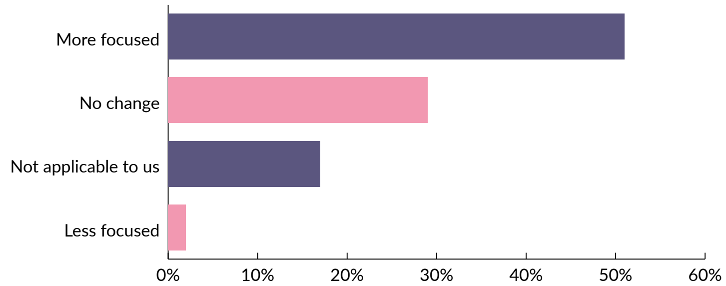
M&A in the current economic climate

Fig 5: What is your firm's M&A strategy in response to the current economic climate?



The single most prominent view among firms is that the current economic climate has encouraged them to accelerate their M&A strategy. Just as Coronavirus forced people to critically reassess their agile working methods, it appears to have also forced firms to reassess their need to make more fundamental long-term changes.

Fig 6: In this economic climate, how has your focus on new deals changed over the last year?



Following on from that, we saw that more than half of firms are now more focused on carrying on with their strategy and very few are less focused.

This is an interesting statistic when you consider that most firms' strategies over the past year or so have naturally been more inward facing.

So, what is fuelling this appetite for M&A?

When we asked firms what their key driver behind their M&A strategy was, half said they hoped to 'futureproof the firm'.

However, what constitutes 'futureproofing' is likely to be very broad.

While some firms consider that recent disruptions have generated opportunities for acquisition, there are many more that have found themselves reluctantly in this position and, in some cases, where being acquired is the only way to avoid a wind up.

For firms that are able to take advantage of the opportunities, we have been told that there is a wider pool of potentially cheaper deals to be done, as the number of firms being forced to plan an exit strategy has increased.

Availability and affordability of professional indemnity insurance in a hardening market has piled extra levels of pressure onto already struggling firms. Some firms can find themselves trapped between a rock and a hard place – being forced to continue in practice while funding these growing premiums just to avoid triggering unaffordable run off insurance premiums. For these firms, being acquired is their only workable prospect.

Changes in the professional market, such as the closure of the Solicitors Indemnity Fund (SIF) to new claims from September 2021, will fuel this even further. The removal of the SIF effectively opens the door to historic claims for individual partners who were previously protected by the fund, and so partners approaching retirement will now be looking much more sharply at finding a friendly successor practice.

A less immediate but nonetheless important factor that is driving the demand for acquisition is pricing and there is a real divide here between the 'haves' and the 'have nots'.

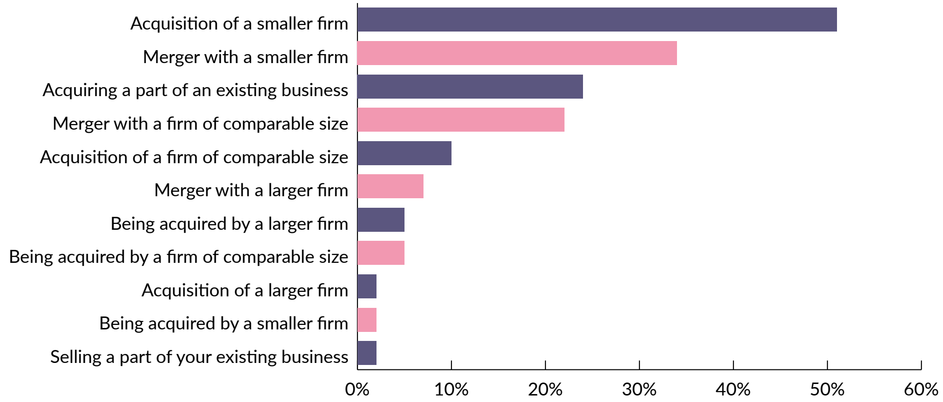
For some firms, pricing is an art, and whereas in the past (and ignoring success and contingent fee structures) there were generally two types of pricing: fixed fee and hourly rates, that has become much more nuanced. For example, we have seen firms offering pricing menus where clients can control their costs by selecting which elements of a full service they actually want, and can even choose who does the work.

For those firms unable to keep pace with innovative pricing models, or those that are unable to capture and communicate the value of the work they do, they have started to see challenges to their market share and some have ultimately fallen behind the pack.

Acquire or be acquired?

With all of this in mind, we asked firms what their M&A strategy looks like – is the market full of buyers or sellers and is there actually such a thing as a true merger?

Fig 7: Are you considering any of the following as part of your firm's M&A strategy over the next 12-24 months? *(participants could select multiple options)*



It is not surprising that more than half of firms cite acquisition of a smaller firm as being a key part of their M&A strategy. This really supports the point made earlier: there is a greater appetite for M&A now than at any point in recent years, and this is likely to be fuelled by opportunistic acquisitions as the gap between the successful and the unsuccessful gets wider.

55%

of firms are considering merging with a firm of similar or smaller size

However, more than 55% of firms said they are considering merging with a firm of comparable or smaller size, and that raises the question as to what a firm actually thinks of when it thinks 'merger'.

David Sparkes, CEO at Millbourn Ross comments:

"The report provides an interesting perspective on the mindset of professional services firms and their attitude to strategy. The report highlights a strategic disparity between the primary threats perceived by respondents which are all people related ie attracting and retaining staff and succession planning, and the potential benefits of a merger, which are financial related ie consolidation of costs and sustaining profitability.

"Firms that enter into M&A must do so with a clear vision for the future and clarity as to the outcomes they expect to achieve. A way to achieve certainty of outcomes is to invest in the on-boarding and integration process. The strategy of professional services firms is under the spotlight and leaders have a responsibility to articulate an executable strategy that futureproofs the business. M&A should be focused on creating opportunity over and above finding solutions to problems.

"An overwhelming number of respondents cite organic growth as the driver for their growth strategy. However, organic growth in a mature market like professional services is not without its challenges. As firms increasingly look to compete through scaling beyond the 5%-10% annual growth that an organic strategy may deliver, the question must be asked - is organic growth enough if everyone around me is seemingly more ambitious?

"For those firms who see themselves as 'acquirers' the focus will be on control. This theme is reinforced in the respondents desire to acquire over merge and further reinforced by the desire to look at smaller firms. Smaller firms are attractive because they are potentially more digestible and the larger firm can on-board to its own culture, vision and values.

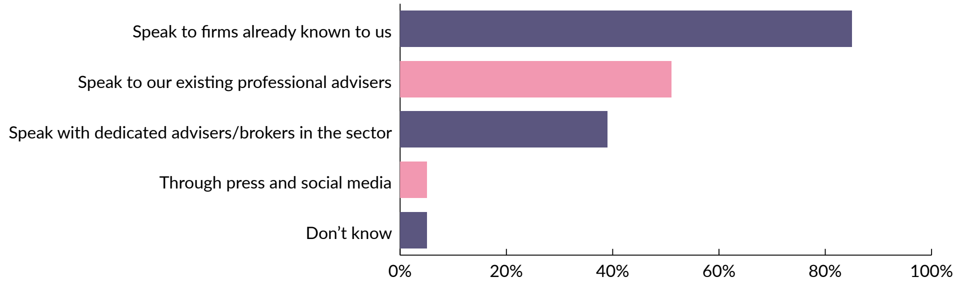
"When it comes to planning for M&A, many firms demonstrate the same opportunistic behaviours by exploring their own network of peer firms as a starting point and then leaning on professional advisers and eventually sector specialist brokers/advisors. At the other end of the spectrum, we find firms take a much more pro-active approach to origination and apply a more sophisticated methodology of market mapping, identification and approach, which ultimately yields results that are targeted and timely."

www.millbournross.com

Laying the foundations for a merger or acquisition.

Going back to an earlier statistic, we know that over 40% of firms have accelerated their M&A plans, and more than half have an increased focus on M&A, but of course what this means in practice can be very broad, so we wanted to understand how firms actually go about pursuing a strategy and, in particular, where they would start looking for a potential merger or acquisition candidate.

Fig 8: If you were interested in a merger or acquisition, where would you start looking?
(participants could select multiple options)



Almost all firms said that their most likely starting point would be to speak with firms already known to them.

There are clear advantages for firms in restricting their search like this, and firms that are already familiar with each other, even on a purely competitive basis, may already have a good idea of the culture of the other. This should help smooth the integration process, but by its nature is a fairly limited approach.

Around a half of firms will speak to existing professional advisers which is of course helpful in getting an expanded view of the market, but is not an approach to rely on solely.

Taking a law firm as an example (and assuming that one of their main professional advisers is a firm of accountants), it is more than likely that the law firm itself already knows a much wider range of potential targets than their adviser, and is probably closer to the key individuals in those target firms. Therefore, it is important that a professional firm looking for external assistance makes sure that it is asking questions of an adviser that understands their chosen market, and has their own, already well-established network in place.

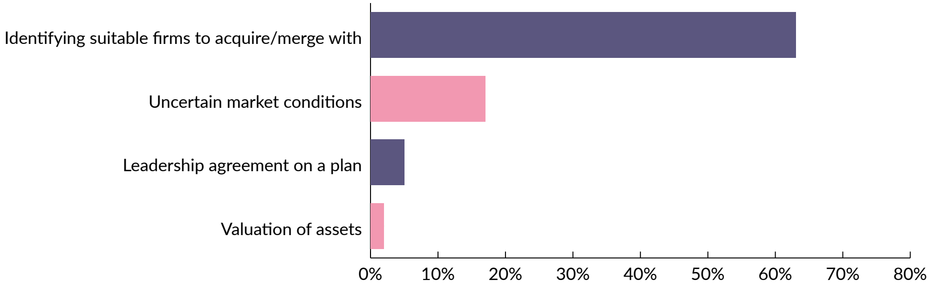
Barriers to success

There are clear barriers to success, but the main issues usually fall into a small number of identifiable themes:

- Practical – can we actually find a suitable merger partner?
- Cultural / softer issues – will there be a dilution in brand, and will the staff feel invested in the new firm?
- Technical – can systems and controls be aligned so that the firm can run efficiently?
- Financial – will the merger result in everybody being financially better off?

We will deal with cultural and technical issues in the next section, but of the practical and financial aspects, it is the practical issues that are most prominent when firms assess the biggest threat to as successful merger.

Fig 9: What do you see as your biggest challenge to M&A success?



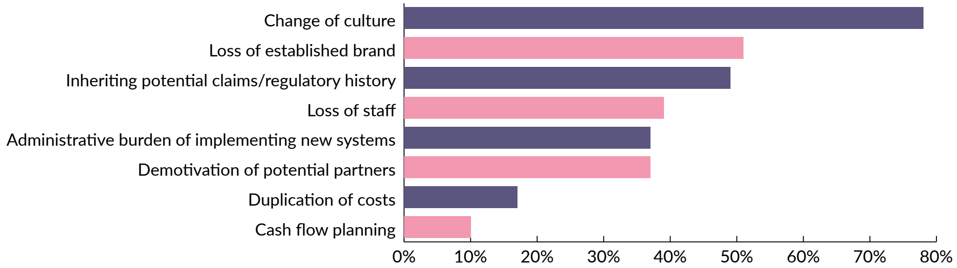
Risk vs. reward – what makes a merger worthwhile?

Aligning the cultures of firms is a challenge that faces all firms, however well thought out and executed the process itself is and, as our results show, this is the primary consideration for firms.

There always needs to be a certain amount of sensitivity on all sides. For example, where a large, dominant firm acquires a smaller firm, the natural presumption will be that the larger firm's culture will, over time, persist and prevail. In some cases, the newly merged firm will eventually just become a larger version of the acquirer, at least from the point of view of the public, but that change will take place internally too. There may, for example, be a presumption that the dominant firm will have the more sophisticated operations and internal systems and controls and, while in many cases this is probably true, this may not always be the case.

Firms will ignore the opportunity to embrace new, potentially more efficient, business practices at their peril. Is bigger automatically better?

Fig 10: What do you see as the greatest potential threat to your firm of a potential merger? *(participants could select multiple options)*



Almost 80% of firms cite change of culture as being the greatest potential threat from a merger, with over a half also noting a loss of established brand.

In practice, separating brand from culture is difficult and there has been a real shift in focus over recent years among rising stars in law firms who 'buy into' a firm for the whole package. They are not solely basing career choices on salary expectations, location, progression route etc. – but actually a highly nuanced combination of everything the firm stands for. Some individuals may choose to commit to a firm because they feel aligned with its values, and the firm's brand plays a large part in how the firm communicates those values. Upsetting this balance may create problems at both staff attraction and staff retention levels.

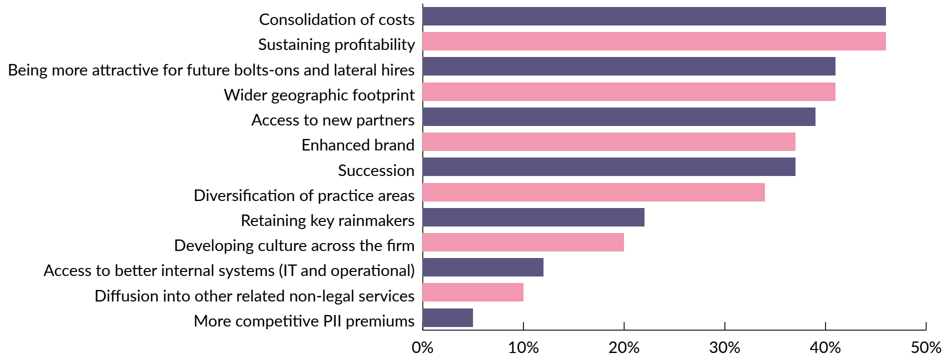
It is important that firms invest time in planning for, and dealing with cultural differences and do what is necessary to avoid creating silos within a newly merged firm – and that doesn't just mean moving everybody under one roof. If the teams refer to each other using the names of their previous firms, then something hasn't worked and needs to be addressed quickly.

Rather than being the primary concern, the potential financial impact of merging sits low down the list of priority factors – 17% are worried about duplicating costs and fewer than 10% cite cash flow planning as being a concern – it is clearly the management of 'softer' issues such as staff satisfaction and demotivation that take priority.

Almost half of firms are worried about inheriting a chequered regulatory or client claims history and that puts the spotlight on the importance of good quality due diligence.

All being said, firms that enter into a merger with an optimistic attitude and a positive mindset may actually find the process an enjoyable experience.

Fig 11: What do you see as the greatest potential benefit to your firm of a potential merger? *(participants could select multiple options)*



While the challenges and potential downsides of a merger covered a relatively small number of themes, the potential pros cover a wider spectrum.

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