Law Firm Strategy in an Uncertain Economy

Strategy is not just about setting a vision; it is also a question of the day to day imperatives that will make that vision achievable. We may or may not be heading for a double dip in the economy, but the issue of dealing with growth is one that all law firm managers should be considering as both an opportunity and a threat.

In recent years, the question of growth was something of a no-brainer for solicitors. Law firms were revenue-maximising operations, and for most partners this also equated to maximising profit per equity partner. However, times have changed and the issues of turnover, profits and cash flow must be separated and prioritised.

Funding Law Firm Growth

To consider how growth will be funded before considering actually planning growth may seem slightly bizarre, but the importance of the planning process only becomes apparent once the issues associated with funding have been illustrated. Let us consider a simple example:

- Firm X increases turnover by 10%. Given that most costs are fixed, this results in an improvement in profits of around 25%, after tax. So far, so good.

- However, the increase in turnover has increased the firm's assets (i.e. cash locked up) by 10%. Thus, the increase in the top line has increased the firm's requirement for funding by 10%, long before the profits can be realised.

If this is not taken into careful consideration in advance, a gap will appear in the firm's finances. There are effectively only three ways to deal with this situation.

i. Reduce Lock-Up

Clearly, as law firm consultants with a strong focus on financial management, our preference would always be for more effective cash flow management. To put it simply, if the amount of cash locked up can be reduced in line with growth, there will be no extra requirement for funding.

The majority of any law firm's assets will be tied up in Work In Progress and Debtors. A figure of 180 days for these two combined is not unusual, although this is considerably higher than the norm in other sectors. There is therefore clearly room for improvement here.

A reduction of 18 days in this figure should be achievable in many firms, although it will not happen overnight (hence why it needs to be planned in advance). The process is not rocket science, but it requires unstinting discipline. Each department or team should have standards for both WIP and debtor days. Responsibilities should be clearly assigned, and a project leader designated. Anything that is above the standard should be explained, billed or collected. No excuses. Interim billing could be considered, and terms of business must be clear and watertight.

This is desirable in and of itself, but if it is not done whilst the top line grows, then other options will necessarily need to be considered.

ii. Increase Funding from the Partners

Any increase in the firm's assets on the balance sheet must be funded, either from equity or from borrowing. The firm's equity lies in the Profit per Equity Partner – from which the partners must be paid. In many law firms, PEP has been more or less entirely removed by the partners as their drawings, leaving very little capital in the firm. If the extra assets are not to be funded from extra borrowing, the only way in which they can be funded is from the partners.

In better times (or highly profitable city firms), this may not have been such a problem. However, partners' drawings in a significant number of cases have been squeezed. Without changing lifestyle, it is difficult to see how many partners could afford to inject cash back into their firms.

That said, it is highly unlikely that banks will agree to fund the extra lock-up without a considerable contribution from the partners themselves. This may be unpopular, but it is now a fact of life.

iii. Increase Borrowing

The final option to cover the extra lock-up is to increase borrowing, where possible. However, the likelihood of obtaining extra funding from the bank manager without significant guarantees in return is slim. (See our article on managing your banking relationship: Banks, Law Firm Profitability and Management Information)

Even if the bank manager personally looks favourably on the situation, they still have to get any extra lending approved by their credit department. Moreover, the firm's management must decide if increasing their ratio of debt to equity is really their preferred route.

The New Reality

In the past, the managing or senior partner would have approached the bank manager and, more than likely, obtained agreement to an increase in the firm's facilities. This is now unlikely to be the case. Law firms are no longer such inherently profitable, and therefore attractive, customers for banks, and the banks themselves have more restricted credit lines available. When this is combined with pressures on profits, and thus the (lack of) ability of the partners to provide funding themselves, it is clear that management is facing a challenge.

The Bottom Line: Focus on Law Firm Profitability

One way of mitigating the dangers of growth is to concentrate on improving profitability. This may sound obvious, but law firms have rarely been managed for profitability, and healthier profit margins mean greater scope for capital injections from the partners themselves.

The first thing to note here is that economics must trump politics in the partnership. There is no room for partners not 'on board' with management's initiatives, and any potentially divisive figures must be neutralised somehow (perhaps this would be a good time to remove any 'deadwood' holding the firm back in any case). This is a rare opportunity to restructure the firm to be a united, and profitable, partnership. It would be a shame to waste it.

Once everyone is on-side, the firm's cost base can come under scrutiny. This is not a case of sharing the pain equally. Rather, areas (whether they be practice or functional areas) that are not providing sufficient returns should be cut back proportionately, while areas that are holding up well may even need to be bolstered.

Somewhat unfortunately in this regard, by far the biggest outgoings in a law firm are people-related. It therefore follows that the most substantial savings will also be in people costs. Where possible, of course, firms should look to minimise the pain of cutbacks. However, if cutbacks are necessary, they are best to be dealt with openly and honestly up front, as remaining staff loyalty will be crucial.

The early days of a tentative upturn may seem like a strange time to be talking about staff cutbacks, but inefficient firms with unsustainable cost structures will not last long, whether or not the economy heads back into recession. Either way, management must be conscious of the issues.

Managing the Bank Manager: Law Firm Management Information

Regardless of whether the firm's managers actually want (or need) to increase their borrowings, developing and maintaining a good working relationship with the bank manager makes commercial sense.

The days when haphazard law firm management information was good enough are long gone. Communicating regularly with the bank is an important first step, and management information should be complete and forward-looking. This means detailed cash flow forecasts, as well as profit and loss accounts and the balance sheet. The relationship should be managed by a Finance Director, or financially literate partner, with good communication skills. The two are not necessarily mutually exclusive.

If the bank is kept in the picture, then securing funding for growth may be a slightly less painful process.

The Top Line: Planning Law Firm Growth

This all assumes that the firm actually achieves growth. However, if growth is not forecast and planned for, then the above points may well be academic as measures come too little and too late.

Forecasting growth at such an uncertain time in the economic cycle will undoubtedly be an imperfect science, but abandoning all to fate will not be a better option.

The starting point is that what gets measured gets better. Law firm business development activities need to be scrutinised in the same way as other outgoings, and for each it is important to note what the return is in terms of new clients, new matters, and sales. Management should also undertake an audit of client profitability, as clients who do not pay in full and on time will not help with the campaign to reduce lock-up.

If the firm is to grow the top line, it would be as well to do so from existing (good) clients. Client care and cross-selling are more cost-effective than targeting new prospects, and this gives the firm more control over its client base. (See our article on Sustainable Business Development for Law Firms)

When activities are measured, client and matter take-on can be predicted with at least some degree of accuracy. This can provide a starting point for predicting growth and the funding requirement.

An Integrated Approach

In most cases, growth will be funded by a combination of approaches. What is clear is that borrowing is more likely to be approved if the firm obviously has its finances in hand, and the partners show a willingness to play their part.

But growth should not be an organic, haphazard process. Growth should be planned, and the funding of growth should likewise be considered well in advance. Otherwise, the upturn may bring some nastier shocks than the downturn for managers in law firms.

Please feel free to contact us for further advice.

Barry Wilkinson and Simon White