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WilkinsonRead & PARTNERS

Making Partnerships More Profitable

In This Issue

Also This Month

Upcoming Events

There are no events this month.

In-House Training

Our CPD accredited training can be a cost-effective way to ensure you achieve results throughout your firm that will impact on bottom and top lines. More information.

The Profitable Partnerships Programme

This law firm business development programme helps partners and key solicitors to measurably and sustainably improve business development performance and profitability. We deliver tracking of performance across a range of key indicators, from new clients and instructions to monthly billing rates. More information.

Blog

Get involved in the debate - read our posts on the issues and challenges confronting your industry, and provide your own opinions on our Blog.

Friday November 30, 2012

Successful Partnerships

Dear Associate,

This month Barry Wilkinson addresses the perils of fixed cost structures, and discusses incorporation in the legal sector.

As ever, any comments or shares are gratefully received.

The WRP Team.

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The Perils of a Fixed Cost Structure

One problem we regularly come across working with law firms is the lack of headroom, or buffer, the partners have when it comes to the firm's cost structure.

In balance sheet terms, the late Professor Larry Ribstein summed it up best – law firms behave as 'thinly capitalised workers' cooperatives'.

Law firm profit margins are usually quoted before allowing for partner drawings, or allocating a notional salary for the partners. If this taken into account, the Law Management Section (LMS) Survey shows that the profit margin is typically only in the region of 5%.

Fixed Cost Operations

In the median firm, fixed costs (most of which can be allocated to people and premises) represent over 90% of the cost structure. In stable, growing markets, firms can get away with having high fixed costs. In uncertain or contracting markets, being able to respond is essential.

If volume falls, the only areas that can be cut quickly are 'decision costs' such as marketing and training. This in itself is likely to produce a vicious cycle of decline.

Cash Management for Law Firms – Ark Group Sector Report

Recognising our expertise in the area, Wilkinson Read & Partners have written a definitive sector report on Cash Management for Law Firms. The report, available here from publishers the Ark Group, addresses in detail the cash flow challenges facing legal firms of all sizes, and details specific strategies for improving cash management and achieving rapid yet sustainable results.

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Fixed Costs into Variable?

A limited amount can be done with IT, by using cloud storage and replacing hardware, and procuring software as a service. Similarly, property contracts can be renegotiated as they expire or to include break points.

However, people costs represent the majority of the fixed costs in a law firm – and so people costs must be made variable, and ideally not be cutting the partners' drawings.

Business processes can be outsourced, including secretarial and transcription services, IT, finance, HR, and most non-fee earning functions, and mid-market firms could exploit this far more than they have to date.

Legal process outsourcing has already reached a market size of $1bn and is growing at a compound rate of 85% per year. So far it has largely been exploited by larger firms, but is increasingly becoming available to consortia of smaller firms.

Breaking Even

In the short term firms can maintain their cash flow through better lock-up management. However, the bottom line is that in the medium term the break-even point simply has to be lowered.

This means that fixed costs must be reduced, and in many case replaced by variable cost structures. This may be unpopular with many people in the firm, but it is better than the alternative when firms start to struggle to break even.

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To Incorporate, or...

The growing trend towards incorporation, and away from the traditional partnership model, raises the question again of what benefits there are for partners from incorporating their business.

SRA figures show that the number of traditional partnerships in the country has fallen by 26%, to just under 3,000, in the past 3 years. The number of incorporated companies has almost doubled, also to nearly 3,000, and LLPs have increased in number by over 50%, to more than 1,500.

Most partners who decide to incorporate their firms do so for two main reasons – asset protection and tax benefits (especially for profitable firms where the partners would be subject to the 50% rate of income tax).

However, there are more issues to consider in the context of running a firm.

The LLP

Converting to an LLP from a partnership is simpler and less disruptive than incorporating, and maintains the 'feel' of a partnership – and, of course, liability is limited.

However, an LLP is still essentially an 'all or nothing' equity membership, and potentially features all the inherent management difficulties of a partnership.

Remuneration is a tricky issue, as profit is a combination of 'salary', 'interest' and 'bonus', and it is thus much harder to match remuneration to performance than it is in a limited company.

Furthermore, the culture of profit extraction, which can lead to weak balance sheets and a lack of headroom in financial management (see previous article), remains a significant problem.

The Limited Company
Creating a limited company allows for the separation of ownership from management, which ultimately smooths the decision-making process. New owners can be brought in incrementally, and owners can also make phased exits – which neutralises many of the succession issues firms face.

The focus on growing share value creates a culture of growth rather than the culture of extraction that pervades the legal profession, and selling an incorporated firm may also be easier.

Nonetheless, banks will still require personal guarantees from the incorporating partners. Changing the ownership structure will require negotiation and possibly external advice, and some 'partner level owners' may be less committed if they have earned their shares rather than subscribed their own cash.

The decision to convert the firm's ownership structure is not one that should be taken lightly, and different firms will arrive at different conclusions. Ultimately, the choice should be based on a sober analysis of the costs and benefits – financial and managerial – of each structure.

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