ALM Intelligence

A New Approach to Law Firm Mergers:
Lessons Learned From 15 Years of Consolidation

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March 2017

Contents

Introduction

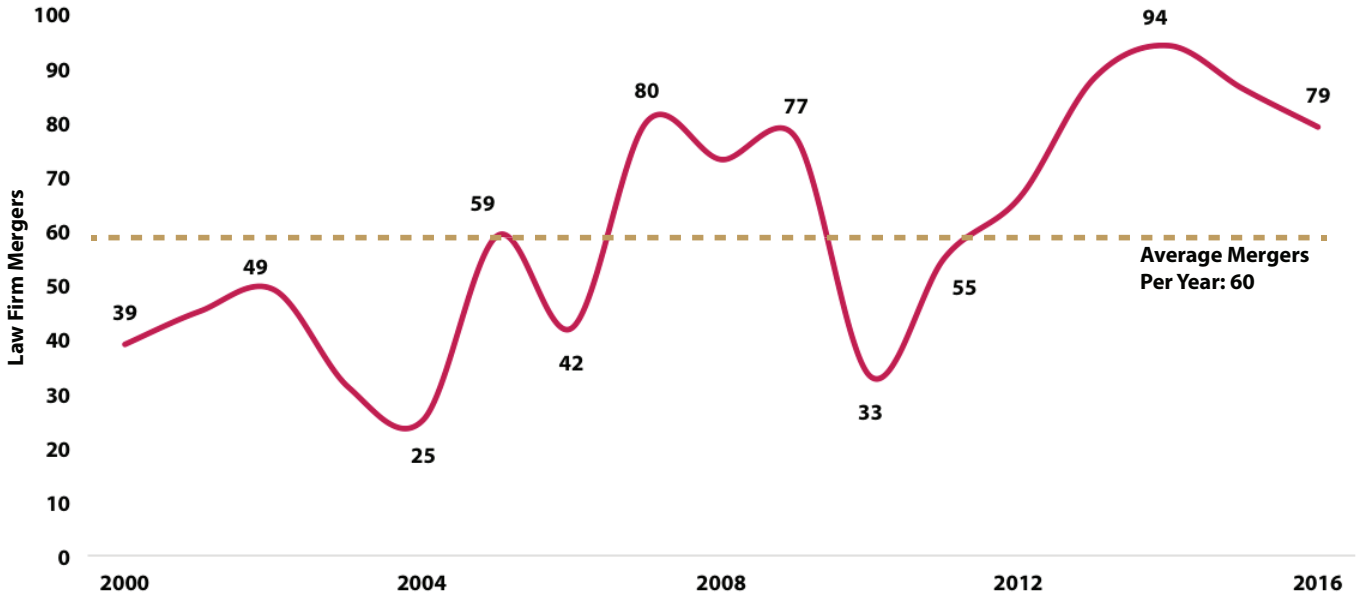
Over the past decade and a half, law firm mergers have transformed the legal industry. These consolidations, which range from mergers of equals to acquisitions of smaller firms by larger ones, have allowed law firms to build both vast scale and some of the legal market's most recognized brands. In 2016, 40% of the largest 25 firms in the world were created from major mergers or a series of mergers that fundamentally transformed the original firms.

Traditionally, firm leaders have tended to view mergers optimistically, hoping that the benefits of greater scale outweigh the downsides of greater complexity. ALM Intelligence's analysis, which was supported by interviews with law firm leaders, suggests that in many cases, such an optimistic view may be wrong-headed.

Achieving an advantageous outcome from a merger is more difficult than law firms anticipate. ALM Intelligence's analysis of large mergers, defined as those involving Am Law 200 firms, reveals that mergers are often destabilizing events that create firms that struggle to grow and manage costs effectively. In the average law firm merger, 6% of partners depart for other firms directly before or after the merger, leaving the merged firm smaller and weaker. This helps explain why ALM Intelligence's research finds that the average merged firm tends to grow revenue more slowly and accumulate costs faster than its peers.

These findings should concern law firm leaders. Nearly 70% of Am Law firms have taken part in a merger of some form since 2000. While the number of mergers has decreased slightly over the past several years, it remains well above the historical average (see graph below).

Law Firm Mergers by Year



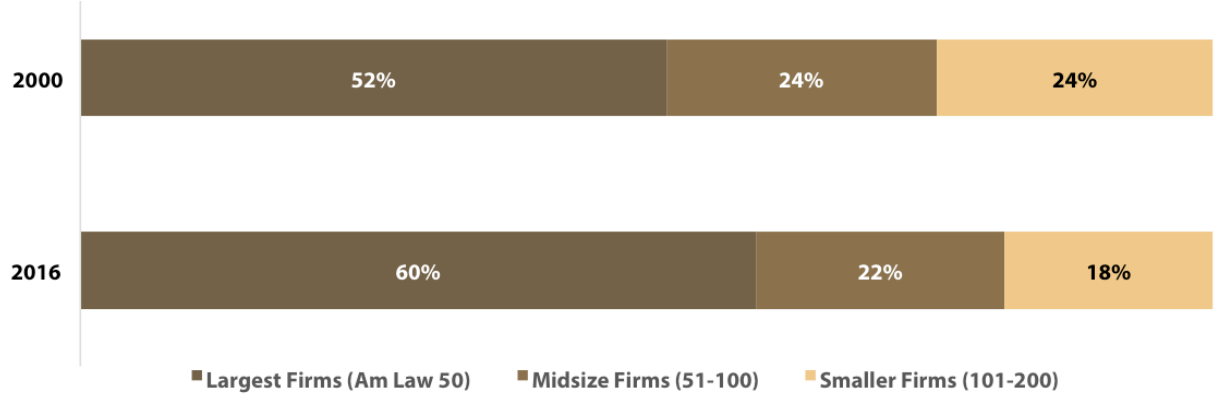
Source: ALM Intelligence

Note: "Law firm merger" is defined as any combination of two firms, regardless of size, that the firms themselves describe as a merger.

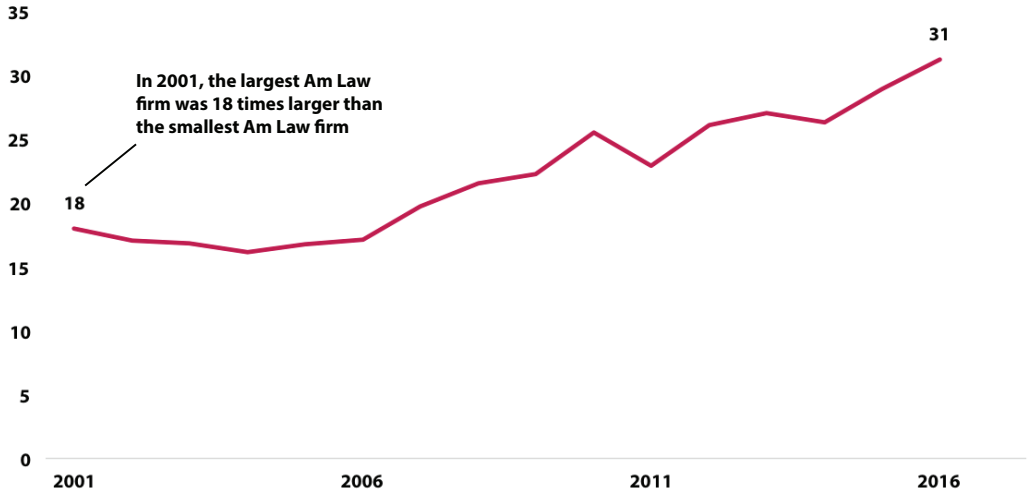
Put simply, law firms require a new approach to evaluating merger opportunities. While mergers offer law firms many benefits, they also pose many risks. ALM Intelligence's research suggests an approach that puts more emphasis on understanding the complexity of executing the proposed merger. This approach should help firms scrutinize merger opportunities more closely and weigh the potential benefits of the combination against the likely costs.

The Impact of a Decade and a Half of Law Firm Mergers

Consolidation in the Legal Industry
Revenue Share of Am Law 200



Increase in Scale: A Growing Gap Between the Largest and Smallest Firms
Revenue Multiple of Largest vs. Smallest Am Law Firm



Top 25 Global Firms (2016)
Firms Created From Transformative Mergers or a Series of Mergers

Global 100 Ranking	Firm Name	Revenue ($M)	Lawyers	Countries With Offices
2	DLA Piper	$2,481	3,702	31
3	Baker McKenzie	$2,430	4,363	47
11	Norton Rose Fulbright	$1,814	3,461	27
12	Hogan Lovells	$1,780	2,360	20
16	Herbert Smith Freehills	$1,344	1,868	16
17	Morgan, Lewis & Bockius	$ 1,317	1,338	10
19	Dentons	$1,275	2,285	30
23	CMS	$1,243	2,522	33
24	Mayer Brown	$1,223	1,486	10
25	Reed Smith	$1,152	1,638	9

Source: ALM Intelligence

Growth Synergies From Law Firm Mergers: The Promise and the Reality

The Promise of Stronger Growth

The primary argument for law firm mergers has typically been that greater scale creates enhanced growth opportunities. Typically, firms have focused on cross-selling to existing clients as the biggest growth opportunity. The combination of two separate firms, each with its own practice area strengths and client lists, creates the possibility of leveraging the existing client relationships from each pre-merger firm to sell the other pre-merger firm's services. That outcome, if realized, would boost revenue and profit significantly.

The second growth opportunity firm leaders typically consider is the larger platform that the merger promises to create. Firm leaders often hope that a larger firm, with a wider range of services in a larger number of jurisdictions, will be more successful at winning new work. This, in turn, would lead to faster growth in revenue and greater profitability.

The success or failure of these opportunities rests on clients' willingness to consolidate their spending at the merged firm. If clients do not believe there are benefits to consolidating their legal spending, a larger platform is unlikely to succeed. Similarly, if the clients do not believe that the firm has the required quality across its range of services and geographies, they are unlikely to be tempted by the one-stop-shop value proposition of a larger platform.

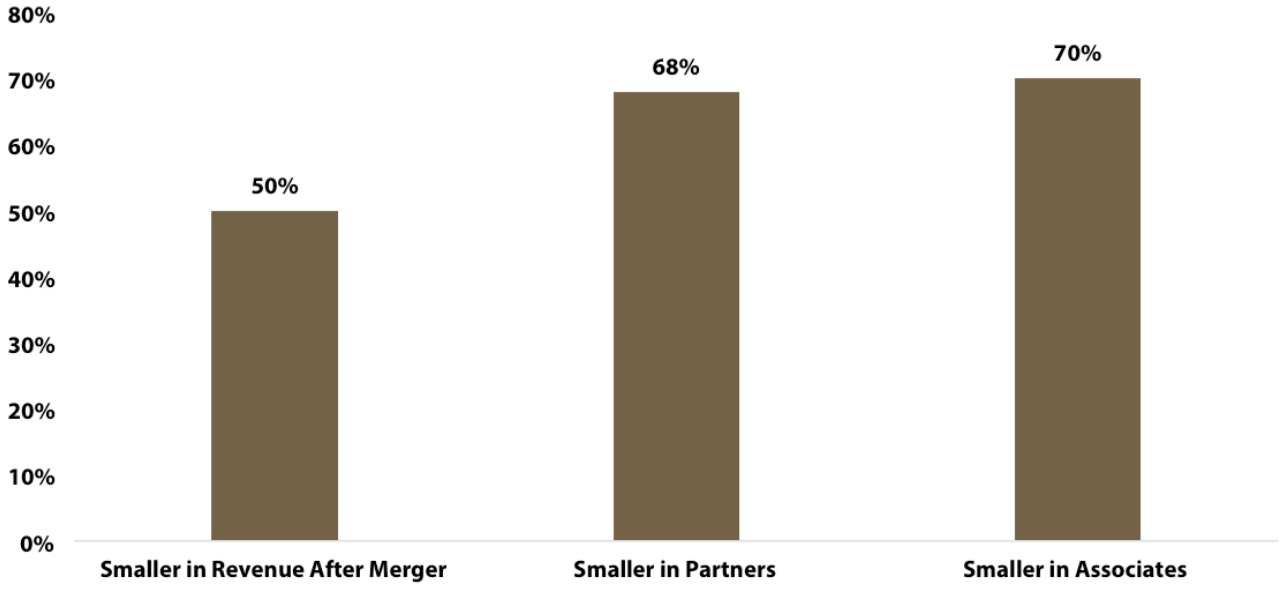
A Quantitative Analysis of Merged Firms' Revenue Growth

In theory, law firm growth is an attractive benefit of a merger and appears achievable. In practice, however, that benefit has been difficult to capture. ALM Intelligence's analysis of 50 large law firm combinations, defined as those involving two Am Law 200 firms, shows few mergers have lived up to the promised result of faster growth.

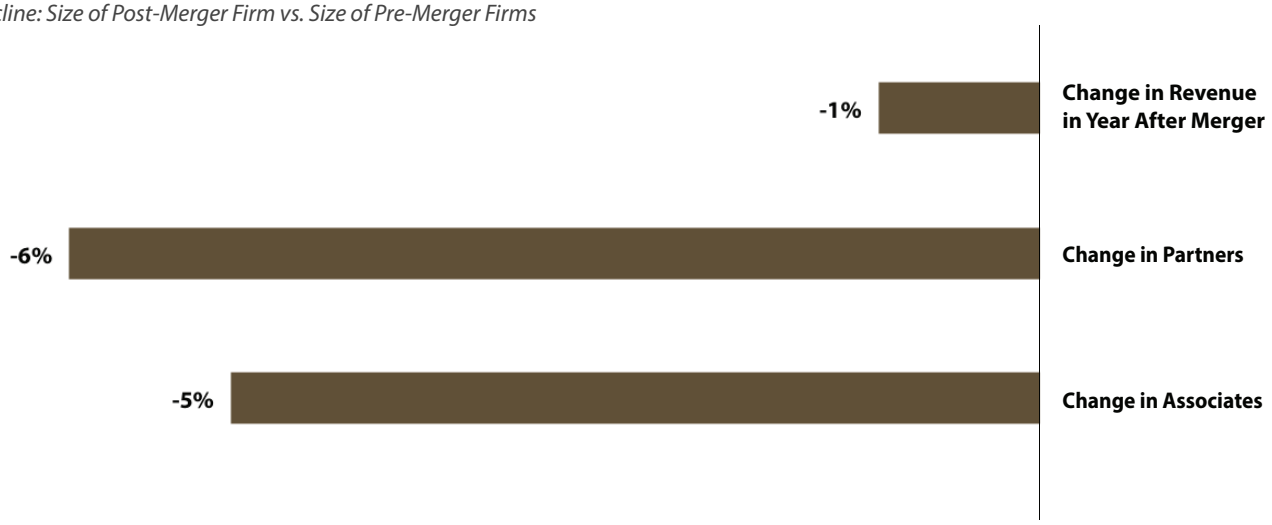
One factor that has stymied the growth of many consolidated firms is partner departures. ALM Intelligence's analysis of large law firm mergers reveals that the impact of partner departures and the corresponding loss in associates and revenue is significant in a majority of these mergers.

When merged firms reported their annual headcount and revenue figures to ALM Intelligence for the first time, over half of merged firms were smaller than the combination of their pre-merger firms in their last year of reporting. The average merged firm lost 6% of its partners and 5% of its associates (see graph on following page).

Partner Departures and Revenue Loss Resulting From Mergers
Percentage of Merged Firms That Were Smaller Than Pre-Merger Firms



Average Decline: Size of Post-Merger Firm vs. Size of Pre-Merger Firms

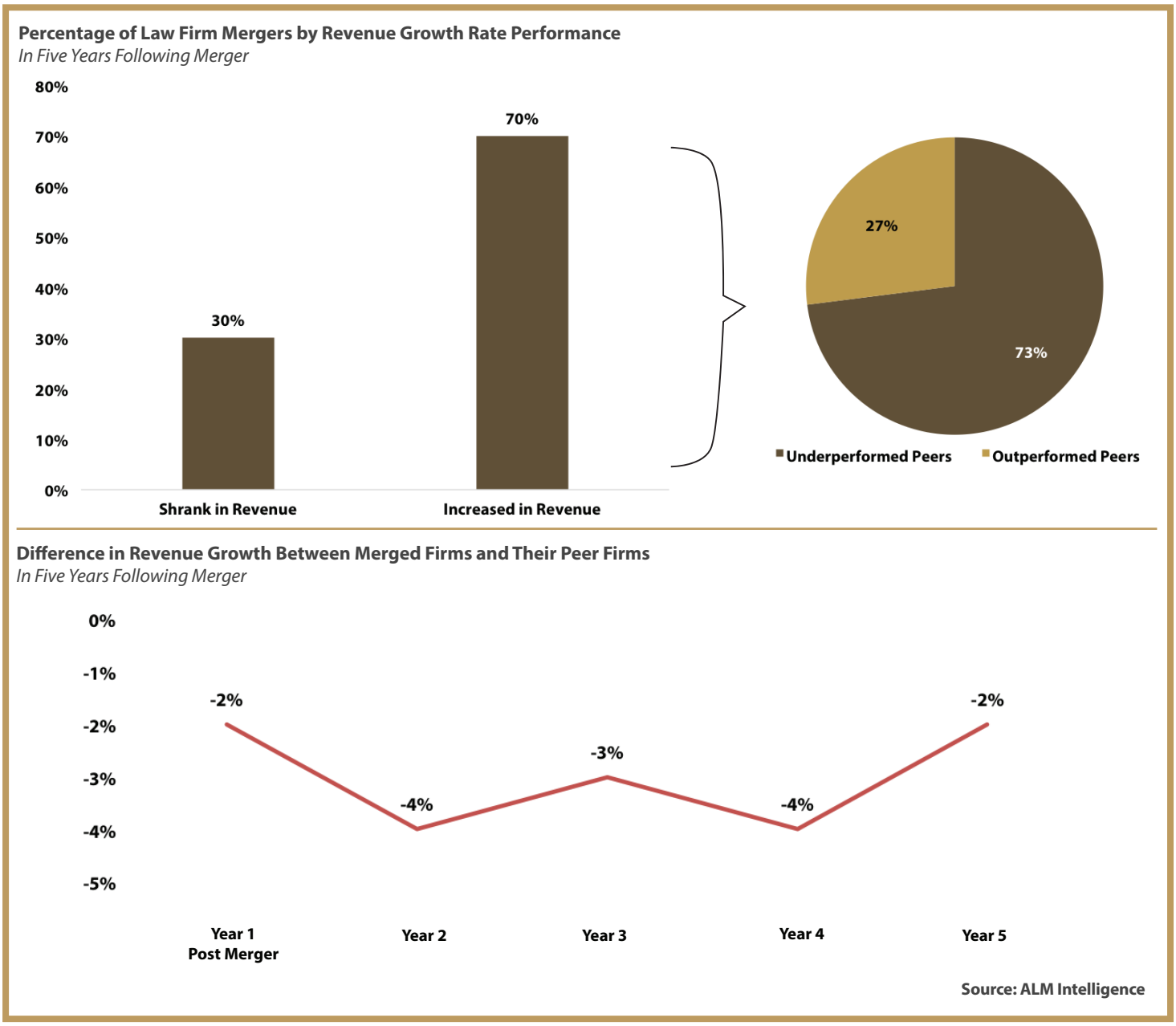


Source: ALM Intelligence
Note: Figures compare merged firm's Am Law 200 headcount and revenue firgures in first year of combined reporting against the last year of Am Law 200 reporting for pre-merger firms

These departures are troubling. Partners typically leave with some portion of the revenue associated with their client book, resulting in smaller firms. The average merged firm was 1% smaller in revenue terms than the combination of the pre-merger firms in the prior year of reporting. At first glance, the data suggests that the merged firm lost significantly less revenue than one would expect from the level of partner departures. It is important to note, however, that the comparison being made is the revenue of the merged firm at the end of its first year and the revenue of the pre-merger firms in their final year. Twelve months separate these two reporting periods. In that time the merged firm would have been expected to grow at levels similar to that of its peers. ALM Intelligence's analysis suggests that if the merged firm's expected revenue growth was incorporated into the reported data, the real cost of mergers on revenue growth would be closer to 6%, roughly in line with the level of partner and associate departures.

More worrying than losses from departures is the fact that ALM Intelligence's research shows that the merged firms created from the combination of two large firms tend to underperform in terms of revenue growth in the five years following the merger. One in three merged firms failed to grow at all, ending the half-decade after the merger smaller than when they initially combined (see graph below). Nearly three-quarters of firms underperformed their peer group (defined as firms with similar revenue per lawyer and profit per equity partner) in terms of revenue growth. Importantly, merged firms' underperformance was consistent throughout the five-year period. In the first full year as a combined firm, the average merged firm underperformed its peer group by 2% in terms of revenue growth. Performance weakened over years two through four, and remained below the peer group in year five.

Revenue Growth of Merged Law Firms in the Five Years Following Merger



Interviews with firm leaders point to three primary culprits to explain why merged firms underperformed in terms of revenue growth:

1. **Partner departures weaken practice competitiveness:** Firm leaders reported that departures impacted the firm's practices differently. Some practices were barely affected, while others saw a large number of departures. In the latter cases, the firm's ability to win work was permanently hurt, and revenue growth declined correspondingly.
2. **Cross-selling failed to materialize:** In many cases, cross-selling proved more difficult than firm leaders had appreciated. In some cases, firms overestimated the strength of their relationships with existing clients. In other cases, firms overestimated clients' desire to consolidate spending.
3. **Management distraction:** Senior partners consistently reported that the process of merging the two firms was more time-consuming than either firm's leadership had planned for. Firm leaders believed that initiatives focused on executing the merger distracted partners from revenue-generating activities and impacted the firm's ability to win and retain work.

Lessons Learned: Mergers Focused on Enhancing Core Competencies Are More Successful

While a majority of combinations of large law firms fail to create an environment of enhanced growth, some are successful. Although it is difficult to define the silver bullet that creates a successful law firm merger, some general lessons can be gleaned from the data and from feedback from law firm leaders.

One consistent theme to arise out of interviews with law firm leaders was the difference in outcomes between two broad types of mergers. Firm leaders largely categorized mergers into two broad groups: those that were targeted at building on the pre-merger firm's core competencies, and those that were targeted at expanding the firm's reach into new peripheral capabilities.

Mergers focused on peripheral capabilities were those that attempted to expand the range of services that each of the pre-merger firms offered. In these scenarios, the pre-merger firms were seen to have complementary, but not overlapping, strengths. Often, the goal of combining two complementary firms was to create a merged firm that could offer services in more geographies, more practice areas, or to a wider range of client types. Interviews with law firm leaders suggested these mergers were more common but less successful. The underlying rationale for these mergers was typically built upon the promise of cross-selling and the belief that a larger platform would result in stronger growth. As shown in the analysis above on merged firms' revenue growth performance, such an outcome is often more difficult to accomplish than many firms appreciate.

Mergers targeted at core competencies, on the other hand, focused on building strength in geographies or practice areas in which the two pre-merger firms already enjoyed a strong reputation. In these scenarios, the two pre-merger firms had overlapping strengths. These mergers were seen as less complex and significantly more successful at facilitating growth.

This suggests law firms that are looking to boost revenue growth would be wise to focus their merger efforts on building on their existing strengths instead of expanding into new geographies, client types, or practice areas.

Cost Efficiencies: Greater Scale Versus Greater Complexity

A second argument for law firm mergers is cost efficiencies. While this rationale is rarely the only underlying reason for a merger, it is often an important component. Law firms have significant operating expenses related to management, support staff, and overhead. Firms hope that greater scale will allow them to leverage their non-fee-earning staff more effectively and provide them more power in procurement negotiations in areas related to rent, technology, and other overhead expenses.

Potential Impact of Cost Reduction on Law Firm Finances and Partner Payouts
For Average Am Law 100

Cost Reduction	Increase in Profit ($M)	Increase in Profit Margins	Increase in Profit Per Equity Partner	Increase in Average Equity Partner Pay ($K)
1%	$5	1%	2%	$25
5%	$25	3%	8%	$124
10%	$50	6%	15%	$247

Source: ALM Intelligence

The potential benefits of cost control are significant. A 5% reduction in total costs for the average Am Law 100 firm would increase profit by $25 million, boost profit margins by 3%, and lift profits per equity partner by 8% (see table above). Such an outcome would enhance the firm's ability to attract and retain talent and invest in initiatives that could make the firm more competitive.

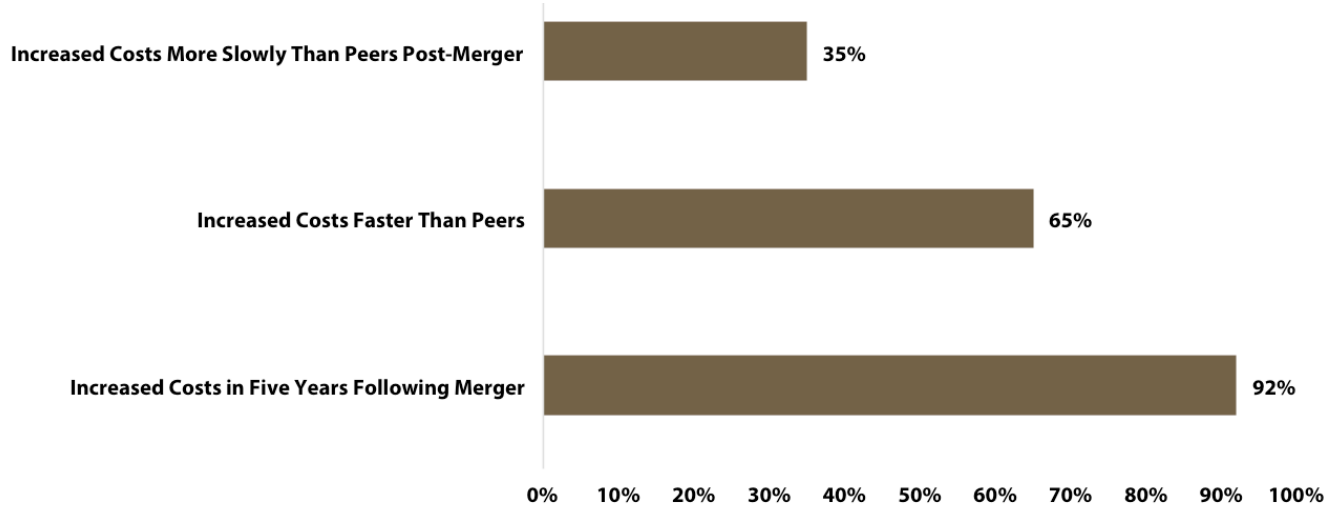
The Reality of Cost Efficiencies Versus Greater Complexity

The argument for cost efficiencies relies upon the expectation that the economies of scale that mergers create outweigh the costs of managing a larger, more complex firm. In interviews, many law firm leaders admitted that their management team was always uncertain if a merger would reduce costs. What many merged firms discovered was that costs, on a per-lawyer basis, often increased post-merger.

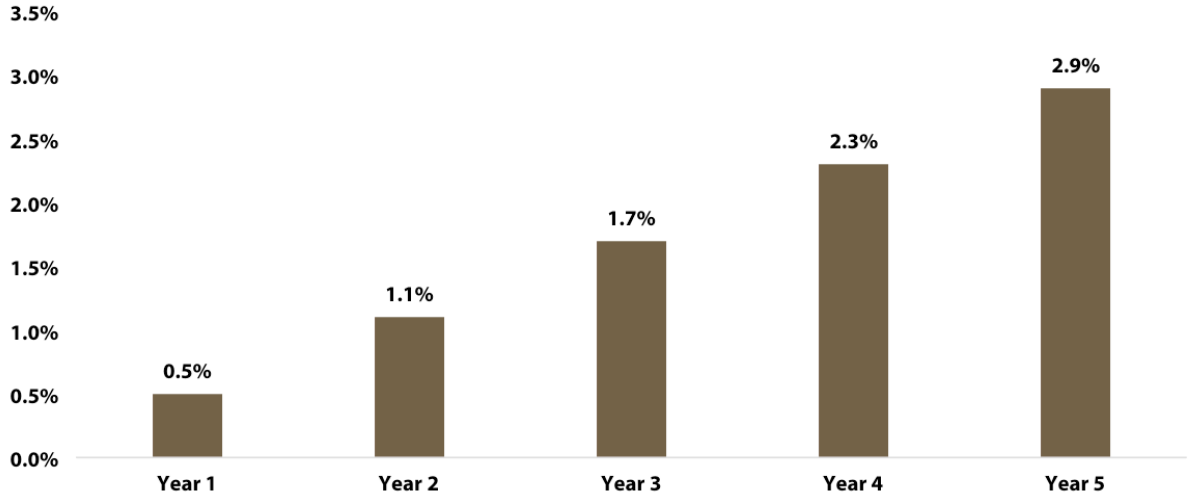
ALM Intelligence's analysis of large law firm mergers shows that 92% of merged firms saw cost-per-lawyer increases in the five years following the merger. Sixty-five percent of firms saw their cost per lawyer increase at a faster rate than their peer group. By the fifth year post-merger, the average merged firm had seen its cost per lawyer increase by 2.9% more than its peer firms. For the average Am Law 100 firm, such an increase would result in an additional $15 million in costs and a 4% reduction in profits per equity partner.

Cost Per Lawyer of Merged Firms in the Five Years Following Law Firm Merger

Percentage of Law Firm Mergers by Cost Control Performance
Cost Per Lawyer in Five Years Following Merger



Difference in Cost Per Lawyer Growth Rate Between Merged Firms and Peer Firms
In Five Years Following Merger



Source: ALM Intelligence

Law firm leaders pointed to four primary reasons why their firms were unable to control costs in the way they had hoped when the merger was proposed:

1. **Limited scope for cuts in non-fee-earning staff:** Non-fee-earning staff at many firms is already at historically low levels, leaving little room for cuts in secretarial, library, marketing, finance, and other support staff.
2. **Limited savings from vendor leverage:** Firms reported that greater scale did allow them to negotiate with vendors more effectively but admitted that the savings were limited in those areas.
3. **Increased management costs:** As firms became larger and more geographically dispersed, firm leaders reported that additional layers of management were required. The addition of new practice leaders and managers of geographic areas not only added overhead expenses but often cost the firms some of their most talented fee earners, because firms were more likely to tap their successful partners for new management roles than hire from outside the firm. The result was a negative impact on costs and revenue.
4. **Increased technology costs:** The existing technology solutions of the two smaller firms were often found to be inadequate for the newly created larger firm. This required the merged firm to abandon existing systems for newer, often more expensive systems. This resulted in significant expenses related to one-time implementation fees and ongoing licensing fees.

Lessons Learned: Smaller Mergers Are Less Complex and Have Higher Success Rates

Law firm leaders reported that one of the key variables that drove complexity and cost increases were the sizes of the two pre-merger firms.

Consolidation of similarly sized firms, or "mergers of equals," were reported to be highly complex and were often seen to have lower success rates and higher cost increases. These mergers typically required significant restructuring of the pre-merger firms. New layers of management were often required to oversee the significantly larger firm. Additionally, new technologies were often needed to facilitate knowledge sharing and communication and to enhance management's clarity into a business that was larger and typically more geographically dispersed than either of the pre-merger firms.

Consolidations of a larger firm and smaller firm – often called mergers but could more accurately be labeled as acquisitions – were, on the other hand, seen to be fairly straightforward, with much higher rates of success and lower cost increases. These mergers typically involved the smaller firm adopting the larger firm's organizational and technological infrastructure, leading to a more organic evolution in organizational and operational complexity and a slower increase in costs. This suggests firms should focus on smaller mergers as opposed to larger ones.

A New Approach to Law Firm Mergers

Assessing Merger Candidates
Issues to Consider

- Vision & Strategic Goals
- Financial Performance
- Practice Area Strengths
- Geographic Capabilities
- Industry Strengths
- Client Profile
- Culture & Management
- Partnership Structure
- Compensation System
- Merger Track Record

Assessing Merger Costs
Issues to Consider

- **Conflicts:** Client conflicts should be assessed for areas of major concern. Revenue losses should be forecasted, and impacted partners should be flagged for potential departure.
- **Reduction in Referrals:** Mergers can cause a partner to rethink his or her relationship with the firm, creating a reduction in referrals. Merger proposals should identify key partnerships that may be at risk and forecast potential reduction in revenue.
- **Partner Departures:** Merger proposals should include forecasts on the number of partner departures and the corresponding loss in revenue that should be expected.
- **Increased Management Costs:** An increase in scale often requires greater management. Merger proposals should include an assessment of the combined firm's management needs and likely cost increases required.
- **Technology Needs:** Firms need to perform due diligence when it comes to the technological infrastructure required for the new larger firm. Those needs should be compared against the existing solutions of the pre-merger firms. Cost increases should be forecasted.

Red Flags
Items of Concern

- **Significant Increases in Scale:** Large increases in scale can require significant organizational and operational restructuring.
- **Increased Geographic Dispersion:** The addition of new offices in far away locations can require new operational models and increased management needs.
- **Mergers Premised on Cross-Selling:** Increases in cross-selling are often overestimated.
- **Mergers Premised on Cost Reductions:** Few firms have been able to reap significant cost efficiencies from mergers.

A New Approach to Law Firm Mergers

Given these findings, should law firm mergers be avoided altogether? No. While mergers between large firms are often unsuccessful at facilitating growth or containing costs, some do succeed. In order to improve the success rate of law firm mergers, firms considering a merger must learn from these examples and build a new approach to evaluating future opportunities. This research suggests the new approach must be focused on weighing the potential benefits that greater scale can provide against the complexity that such an increase in scale would create (see sidebar on previous page).

Improving Targeting and Candidate Selection

Interviews suggest that most firms are doing a fairly good job at assessing the strengths of potential merger candidates. Where they are lacking, however, is in identifying how the strengths of the two pre-merger firms could be leveraged to facilitate growth.

Currently, many law firms put too much faith in the idea that a larger platform will facilitate growth. Instead, firms should be focused on building on their pre-existing strengths to develop a stronger – not necessarily larger – platform. This suggests that law firms should look more favorably on merger candidates that look similar to them. Firms with similar practice area profiles, client profiles, and overlapping geographies will be able to build on their strengths and develop stronger market positions after a merge.

Due Diligence

A second area where firms appear to be struggling is due diligence. Many firms have approached the issue of mergers optimistically, focusing on the potential benefits as opposed to the likely costs.

An example of this optimistic mindset can be seen in "case for merger" presentations, which firms develop to help leaders evaluate and communicate the potential benefits of a proposed merger. These presentations typically include significant detail on the synergies the proposed merger would create in terms of branding and revenue growth. In interviews, firm leaders admitted that these presentations rarely include a detailed description of the likely costs that would go along with the merger. Firms may be aware of financial issues related to the transaction, but they rarely account for the negative impact the merger will have on partner departures, revenue growth, or overhead costs. Excluding these items is understandable from the perspective of firm leaders who are trying to sell the merger to their partnership. It is inexcusable, however, from a management perspective.

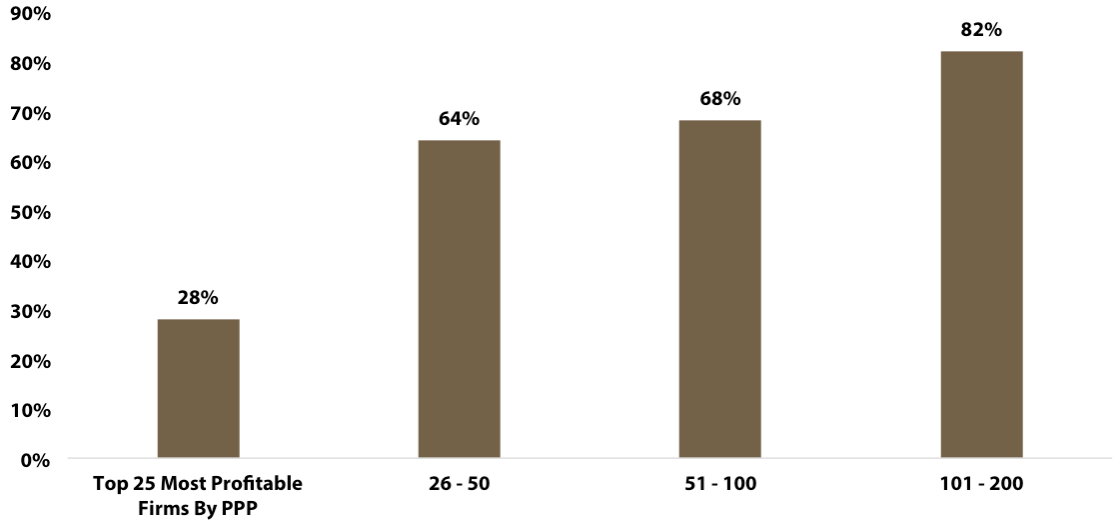
Partners must insist that merger proposals include a detailed description of the costs that the merger could create. This should include optimistic and pessimistic forecasts on partner departures and cost increases related to greater management and technology needs. ALM Intelligence's research suggests that firms should be particularly wary of large "mergers of equals" scenarios. These types of mergers have been proven to be highly complex endeavors that create significant cost increases.

Conclusion

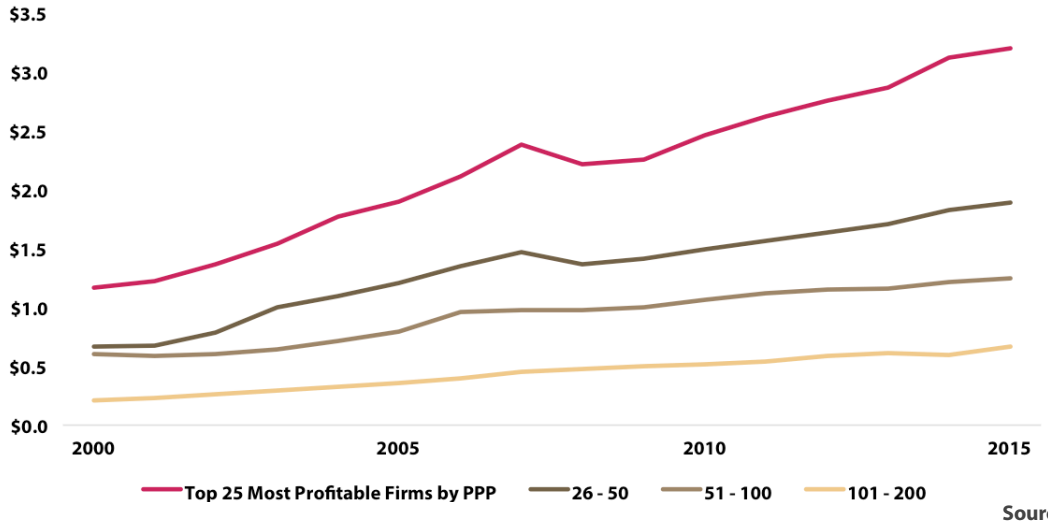
Above all, firm leaders and partners must be more skeptical of the rationale for law firm combinations. Partners, who ultimately hold veto power in merger decisions, should make it clear to their management that vague references about the benefits of a larger platform will not, in and of themselves, justify a "yes" vote for a merger.

Skepticism Toward Mergers by the Most Profitable Law Firms

Percentage of Firms That Have Taken Part in a Merger
2000-2015



Growth in Profit Per Equity Partner
2000-2015, PPP ($M)



Source: ALM Intelligence

Many of the most profitable law firms in the world have taken a more cautious approach toward evaluating potential mergers. Their partnerships have been highly skeptical of the impact that a combination with another firm would have on their firm's brand, culture, and finances. While this outlook has limited the number of mergers these firms have taken part in, it has had little negative impact on their profitability (see graph above).

ALM Intelligence's research shows that a wider range of firms can take a lesson from the skepticism of their highly profitable peers. Mergers consume vast amounts of management time and firm capital. Given their history of mixed results, firm leaders and partners would be wise to approach these decisions with greater rigor.

About the Author

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Nick is a Senior Analyst at ALM Intelligence. His experience includes advising law firms in developing and developed markets on issues related to strategy, business development, market intelligence, and operations. Prior to joining ALM Legal Intelligence, Nick was an Associate with Huron Consulting's Law Firm Strategy Practice in the firm's New York and London offices. Nick holds a Masters of International Business from the Fletcher School at Tufts University and a BA in Economics and Philosophy from DePaul University. In addition to consulting to law firms, Nick has written extensively on the legal market on topics ranging from market segmentation and market entry to future industry trends.

Research Methodology

The methodology used for this report consisted of a combination of sources (including one-on-one interviews with managing partners and other leaders at major law firms), analysis of ALM Intelligence's proprietary data, the authors' practical knowledge of the legal industry, and a review of the body of research conducted by others on the topic of law firm mergers.

The primary data source used for the analysis portions of this report was ALM Intelligence's Law Firm Mergers, Acquisitions, and Closures database, which contains information on more than 1,000 law firm combinations since 1994. Data on law firm financials were sourced from ALM Intelligence's Am Law 200 database, which contains information on law firm financial performance since 1984.

Definitions of Key Terms:

- **Large law firm mergers:** A majority of the quantitative analysis in this paper focuses on "large law firm mergers," defined as combinations of two Am Law firms. These mergers are ideal for analysis due to the fact that the two pre-merger firms as well as the post-merger firm all had publicly released their financial and headcount information to ALM Intelligence.
- **Law firm peers:** To facilitate benchmarking, the financial performance of merged firms was compared against a peer group for some analyses. Peer firms were identified as firms with similar revenue per lawyer and profit per equity partner.
- **Benchmarking time frame:** The performance of merged firms was analyzed over a five-year period. This time frame was chosen to ensure merged firms' performance could be gauged during and after merger integration.