Trends and changes in the legal industry

A Report issued for Samantha at PLS to discuss the trends and potential changes in the legal industry alongside financial analysis of the firm and another competitor. Future investment opportunities are also discussed as well as overall advantages and disadvantages.

1. The Legal Sector and Brexit

Britain opting to leave the European Union shook the country last year. The uncertainty surrounding Brexit has left legal professionals around the world nervously awaiting its impact on the commercial world. During the two year negotiation period law firms will be awaiting news of a ‘ hard’ or ‘ soft’ Brexit and further establishing how each potential outcome could implicate their clients.

1. 1 A ‘ hard or ‘ soft’ Brexit?

A ‘ hard’ Brexit wold involve Britain giving up full access to the single market and losing all rights to free movement within the EU. However, trading would be regulated by the World Trade Organisation suggesting that there would be no ‘ confusion’ politically about the withdrawal from the EU.[1]On the other hand, a soft Brexit would entail staying closely involved with the EU and keeping access to the single market. This would follow Scandinavian models whereby there is no membership of the EU but still access to the single market via the European Economic Area.

1. 2 How Financial Services could be affected

Within the commercial world, financial services would be one of the sectors most affected by a ‘ hard’ Brexit because businesses would lose their passport rights to operate in the EU. London is currently ranked as leading in financial services, meaning that Britain has a large trading surplus in the EU[2]. 7. 7% of the UKs GDP is from outputting financial services with over 1. 1 million employed in the industry and two thirds of them working outside London[3]. Therefore, losing access to the single market would affect many businesses and consequently clients of large commercial firms.

The UK financial service sector has been considering loopholes if a ‘ hard’ Brexit is initiated. As banks are mostly affected by losing EU passport rights, alternative options are being considered if the UK did leave the single market with no deal negotiated (essentially a worst-case scenario situation). [4]Insurance and Asset management are less affected because they tend to be part of a global industry, for example, Lloyds of London[5]. However, many banks including HSBC, JP Morgan Chase, UBS and Morgan Stanley are standing by to move thousands of employees to countries within Europe ahead of negotiations taking place.[6]

A report issued by Shearman and Stirling suggested that there are various ways of trading with the EU without needing a passport[7]. Some of the main loopholes being discussed are:

- Reverse solicitation
- Delegation of fund management/outsourcing of services
- Conduit entities
- Back to back trading[8]

Back to back trading is the most prevalent of the four listed. Banks would sell its services from a local entity to EU clientele but would then transfer to the

UK immediately after[9]. A drawback is that this is a short term solution, but can give law firms more time to find a long term alternative. EU regulators are also likely to frown upon loopholes when they will be relied upon by firms to carry on trading under a ‘ hard’ Brexit.[10]Essentially it is difficult for large commercial law firms to plan exactly how they are going to deal with the loss of passport rights. However, it would be beneficial if the UK attempts to ‘ convince the EU-27 that keeping financial markets open across the Channel is a matter of mutual interest’ because fragmenting ‘ London’s Ecosystem would lead to higher costs for everyone involved’.[11]

1. 3 The Technology sector

Brexit will likely cause little affect to the technology and innovation sector on the premise that the UK stays in the European Economic Area. However, if negotiations mean that the UK fully detaches from the EU, then changes to this sector, as with many others, will be more wide-ranging[12]. Nevertheless, it must be remembered that there are successful countries operating outside of the EU. Norway is a prime example and has a strong presence in the technology and innovation sector without benefitting from EEA tax incentives, research, development, investment and funding.[13]

More specifically intellectual property rights are mostly unaffected because they are not regulated by the EU. However, data protection is a hot topic of discussion. It remains to be seen if businesses within the UK will still be allowed to collect sale activity data via subsidiaries in the EU and whether the UK adopts the General Data Protection Regulation.[14]Technology has the same potential threats as financial services and the two year negotiation period will conclude the next chapter for the legal industry. However, it must be remembered that regardless of the outcome, advice and expertise of commercial lawyers will still be needed.

2. <u>Financial Analysis of PLS and FFS</u>

PLS 2016	PLS 2015	FFS 2016	FFS 2015	
Profitability				
Return on capital employed	50.35% 1: 0.50	48.77% 1: 0.48	91.08% 1: 0.91	81.07% 1: 0.81
Return on sales	27.99% 1: 0.27	27.10% 1: 0.27	31.05% 1: 0.31	32.26% 1: 0.32
Asset utilisation ratio	1: 1.80	1: 1.80	1: 2.93	1: 2.51
Liquidity				

and solvency				
Current ratio	1: 2.63	1: 2.90	1: 2.14	1: 2.40
Liquid ratio	1: 2.63	1: 2.90	1: 2.14	1: 2.40
Efficiency				
Creditor days	191.82 days	160.28 days	174.12 days	164.38 days
Debtor days	233.08 days	209.64 days	198.05 days	188.01 days
Stock days	0	0	0	0
Investment				
Gearing	52.80% 1: 0.52	44.37% 1: 0.44	79.90% 1: 0.79	66.28% 1: 0.66
Return on	48.	47.	87.	78.

	66%	24%	20%	26%
equity	1: 0.48	1: 0.47	1: 0.87	1: 0.78
Interest cover	0	0	0	0

1. Profitability

Law firms are increasingly using profit to measure their firm's success rather than revenue. This is because profit is a more accurate version of how the firm, large or small, is doing financially. Law firms are ranked by revenue so it is understandable to focus on this, but often profit points/important data can be overlooked. A law firm is a business and must always aim to improve profitability.[15]

2. 1. 1 Return on capital employed (ROCE)

ROCE is a ratio that measures how successfully a company is turning its capital invested into profit. A higher percentage indicates a more effective use of capital and therefore an increase in shareholder value. When comparing revenue, FFS has a much higher yearly figure than PLS but its revenue has dropped significantly in just one year (70m).

In 2016, FFS turned 91. 08% of its capital into profit, which is a large improvement from the previous year which measured at 81. 07%. The large percentage of profit stemming from capital investment may be due to a higher amount of reserves being re-entered back into the business. FFS seem to be using their share capital in a more financially beneficial way than

PLS by retaining their reserves rather than distributing them all to members. This may be because recent investments in new offices needed funding. Eventually, FFS will be striving for a larger shareholder value.

PLS has not seen a significant increase in ROCE (less than 2%). This suggests that substantial investment is not occurring. Instead they are using local firms in China, and not reinvesting ‘ profit for the financial year available for division amongst members’. It may lessen their revenue for a while but investing in new offices like FFS could eventually improve their profitability and shareholder value.

2. 1. 2 Return on sales (ROS)

The ROS is a measure of how much profit is being formed per pound of sales. FFS suffered a decrease in their ROS by 1. 21% which may be because of their loss in operating profit.

Comparatively, PLS improved their percentage by 0. 9% from 2015-2016. Where FFS have seen a significant increase in staff costs, PLS have only seen a minor one. Where FFS have suffered a large decrease in turnover, PLS have seen a minor one. PLS may have also focused more attention on the 6 profit points and lessened expenses to improve their overall profitability. PLS is unlikely to be underperforming as it is converting a similar amount of company revenue into profit as FFS, even though FFS has a much higher turnover.

2. 1. 3 Asset utilisation ratio (AUR)

The AUR for PLS has not increased from 2015-2016. This would be because they have not invested in the firm to gain more asset appreciation. Generally, the higher the AUR, the better the company is performing because it would be generating more revenue per pound of assets. FFS have invested in new offices meaning the general equity has decreased significantly since 2015. The equity at PLS has barely changed suggesting a higher inefficiency to deploy assets in order to generate a higher revenue.

2. 2Liquidity and Solvency

2. 2. 1 *Current ratio*

The current ratio portrays the health of the business. A ratio above 1 but no higher than 3 suggests efficiency in utilising assets. Both firms are within this bracket but in 2015 PLS came close to 3 suggesting that they are not investing assets back into the firm as efficiently as they could. This however reduced significantly the next year.

2. 3Efficiency

2. 3. 1 Debtors days

Debtors days is the measurement in days that a firm will take to collect cash from debts. Both firms have rising debtor’s days but it would take PLS longer to receive debts owed as the days have grown by 25 compared to FFS with only 10.

It is well known that billing clients can be a long process and usually the cause for lengthy debtor’s day results from firms. However, clients could also be asking for longer or different credit terms causing the rise for both firms. PLS could take into account purchasing new software to speed up the billing process, generally improving timekeeping and tracking firm financials more acutely to improve their figures.

2. 4Investment

1. Return on equity (ROE)

The ROE depicts a firm's profitability regarding how much profit is made from money shareholders have invested. ROCE and ROE come hand in hand because ROE analyses how much profit is being made from shareholder investment where ROCE assesses how much shareholder investment has gone into the company.

FFS have a much higher ROE, which has increased by 10% in the year 2015-2016. PLS have barely seen an increase in growth suggesting that they are not investing their equity efficiently enough. Although FFS have suffered a massive reduction in revenue and remuneration to members, their investment from equity seems to be paying off. In 2016 87. 20% of shareholder money transferred to profits whereas PLS only saw 48. 66 %. Potentially investing globally with equity money could benefit the overall profitability of PLS.

3. Strategy and the legal industry

All Industries change how they conduct business when assessing potential and current trends in their environment. This is often done by using analytical tools which further evidence changes to strategic positioning.

3. 1 PESTEL

PESTEL is a tool used to identify different trends of the legal macro environment. Politically speaking, Brexit is the most current threat to the legal environment. As a result of a ‘ hard’ Brexit the economy may suffer because large corporations are likely to move outside of the UK.[16]This means that the economy will not only suffer from loss of business but lack of investment. Brexit has already caused many firms to hold off further investment, which may be why PLS are considering opening a new office outside of the EU. The tightening of the government purse will also have an effect on firms, particularly in the energy sector where less contracts have become available.[17]

Social aspects include the changes in loyalty of clients because it is much easier to shop around and choose different firms. It is in the interest of fee earners to keep their clients satisfied so they don’t lose them to other firms.

There has been a significant boom in software and technology recently. Clients of law firms who previously would have sought legal advice now have access to the internet and free online legal tools. However, on a more positive note firms have typically improved timing and efficiency because of billing and database software made specifically for law firms.[18]Most firms have also reduced the amount of paper being used because this is more attractive to environmentally conscious clients.

The Legal Services Act[19]has meant that accountancy firms such as Deloitte and PWC have extended their own in house legal departments. Consequently, large commercial firms have lost clients and further gained competitors. Brexit may also cause loss of employment rights, lessen mergers and acquisitions and could cause various laws to be changed.

3. 2 Porters Five Forces

Porter’s five forces is a tool to assess how competitive forces shape strategy and ultimately profitability. This methodology was initially applied to the legal industry, but ‘ seemed to defy the competitive pressures outlined in Porter’s article, whereby it still experienced a rapid rise in profitability’.[20]However, recent changes in the legal industry has led to re-evaluation regarding the use of the five forces tool, to gain an insight into the competitive market of law.

The bargaining power of suppliers usually refers to the firm’s employees, as they do not have suppliers in the typical sense. There has been a growing amount of legal talent throughout the past three years[21]which means that firms have been able to reduce fee agreements. For example, instead of hiring more solicitors a firm may choose to hire experienced paralegals which would cost significantly less. Although this is positive, it does mean that recruiting fees are higher and may cause retention rates of staff to be lower.

The power of buyers is the most commanding part of the five forces in terms of competitive strategy. Firms have seen less customer loyalty and ‘ less dependency from buying local for legal services’.[22]Legal research charges have also been removed from overall billing which is costing firms millions in added cost.[23]

The threat of new entrants relates mostly to smaller firms using technology to give legal services on the same level as larger firms.[24]This is because technology now allows this, and smaller firms charge significantly less. As PLS is an international firm it may at some point wish to enter a foreign market but some are saturated and are therefore hard to enter and be successful.

The threat of substitute products and services has changed because of the Legal Services Act[25]This means that many companies who would have otherwise used law firms, are now investing in their own in house legal departments. Deloitte, an accountancy firm have done this and have subsequently saved in legal fees[26].

This all adds to the most important aspect of the five forces – rivalry amongst existing competitors. However, with trends in the market changing rapidly, further threats in relation to other competitive measures are equally as important and making the market more complex. As in house becomes more popular (6 billion dollars in the US market in 2 years)[27]and client loyalty lessens, firms need to acknowledge that ‘ new service models create separation from rivals and provide the uncontested market space necessary to limit the impact of Porter’s Five Forces on their operational strategy’[28]

4. Organic growth vs Mergers

1. Potential Merger with a local firm

It is seen that ‘ mergers and acquisitions (M&As) are one of the principal ways in which organisations can achieve rapid growth’.[29]They benefit from economies of scale and therefore lower overheads which means cutting costs significantly. Commercial benefits include instant access to client databases and loss in competition with the firm chosen to merge. As PLS are also looking to set up in culture completely different to that of the UK, it would be potentially very beneficial to have access to experienced legal professionals already based in Shanghai who understand the market and clients.

‘ The burst of activity in the last quarter helped make 2016 the second-best year for dealmakers since the financial crisis’.[30]Therefore, more firms are seen to be merging in order to eliminate vulnerability and to make themselves truly global rather than just international. Norton Roserecently merged with Texas’ Fulbright andAshurstwith Australia’s Blake Dawson. Meanwhile, SJ Berwin became the first ever UK firm to join arms with an Asia-Pacific firm, King & Wood Mallesons, in 2013.[31]As PLS are friendly with local firms who they pay for their services, there may be an option for a potential merger with them. It would also mean that PLS do not have to pay to set up their new office in Shanghai which would save a significant amount of money.

There are risks involved with potential mergers. When two companies decide upon this option they may lose aspects of their brand which could cause an array of disadvantages including loss of clientele. It will also likely mean that they have less control over the business and its future. Given the importance of interaction with their foreign customers, PLS should opt for a high degree of control over their foreign market entry mode[32]and a merger does not necessarily give this.

4. 2 Setting up a new office in Shanghai

Organic growth is known to be expanding the business from the inside rather than the outside (M&A). The economic benefit for PLS of investing in a subsidiary office would be that they do not have to pay local firms for their service. They can build their own client database, promote their own brand and have full control of the office. Businesses that grow organically can control their rate of growth and normally face less cultural and integration challenges than those that choose an inorganic strategy.[33]However, they may face cultural challenges with clients.

The risks of organic growth lie in expansion that outpaces the ability to effectively manage, stretches resources too thin, strains capital, or diverts focus from the business' core mission[34]. It would cost PLS a substantial sum of money to invest in the office and is the most expensive of the foreign market entry options.

Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Cash flows (£'000)	(1000)	1,500	1750	2,200	2,650	2,900

Present Value	(1000)	1, 071. 42	892. 86	801. 75	689. 82	539. 21

Net Present value: £2, 995, 000. 06

The investment will add £2, 995, 000. 06 of value to PLS and therefore the office in Shanghai is worth potentially investing in. However, there are some risks involved with the NPV calculation. It does not consider unforeseen expenditure and is often based on estimates. It therefore does not fully account for potential risk in investments costs, discount rate and projected returns.

Essentially, each investment holds significant risk because both a potential merger and buying a subsidiary office are very drastic forms of expansion. Other options such as purchasing a stake in an ‘ associate office’ or forming a ‘ best friend alliance’ may fit the needs of PLS more substantially. [35]Further, they may then decide upon organic growth or a merger once they have definitive evidence that the high risk will benefit the overall firm.

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Declaration

I declare that:

ï‚· The work in this assessment was carried out in accordance with the Regulations of The University of Law.

ï‚· The work is original except where indicated by acknowledgement or special reference in the text, and no part of this assessment has been presented by me or anyone else to any University or body for examination either in the United Kingdom or overseas.

ï‚· I have not conducted research involving human participants for the purposes of this work

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[1]Sims A, ‘ What is the difference between hard and soft Brexit? Everything you need to know’ (*The Independent – UK Politics,* 3rd October 2016)

[4]M Arnold, ‘ Banks study loopholes to enable UK branches to sell to EU clients’, (Financial times, 02 February 2017) accessed 14 February 2017

[5]Booth S, ‘ How to ensure UK and European financial services continue to thrive after Brexit’ (Open Europe, 17 October 2016)