Arden

Consultants, on the march! The New Model Army of Law?

Arden’s report on the growth of the legal consultants, the unique accelerant, poised to benefit from the disruptions of the pandemic

Introduction

Market disruption will be a key theme in 2021 for law firms and legal services providers. The pandemic has acted as a catalyst for the industry, highlighting the poor management and outdated operating models of many law firms. A new model that began as a small tremor five years ago is now turning in to an earthquake for the legal sector. Indeed, on the High Street it may well become the dominant consolidator model, stimulated by the success of remote working during the Pandemic and the benefit of significant investment in IT.

Passing trend or here to stay

The legal consultant business model offers lawyers a central service platform, brand and management infrastructure from which to operate, in return for a percentage of the lawyer’s revenue. The lawyers themselves are self-employed consultants, who retain an average of 70 per cent. of their billings, with the remainder shared with the consultancy firm.

Dismissed as either a passing trend or of minor consequence, the legal consultancy model was not considered to be a true law firm, let alone a rival to established firms, when it first emerged. The ability of the consultancy model to compete and gain significant market share against established firms was doubted when it first arrived. There were significant unanswered questions over the ability of the model to be able to attract high quality lawyers and improve low margins as profit was given up in the pursuit of scale and expansion. Many suggested that lawyers and clients would not be attracted to such an “outsourced” back office model.

In the 3 years following its IPO Keystone, along with several other private firms like Gunnercooke, Setfords and Taylor Rose, has provided clear validation of the consultancy model.

It is now clear that it is not only here to stay but a significant competitive threat to the traditional partnership model, as the High Street and smaller mid-market firms face the need for unprecedented consolidation. Furthermore, it has an opportunity to scale quicker and at lower cost than even the best acquiror models.

Lawyers at Keystone have gone from 267 to 476 since IPO, as growth has continued at a significant rate proving the appeal of the model to lawyers. The revenue growth of the group has also demonstrated the ability of lawyers within the consultancy model to win and retain clients against established firms. At the same time investors have recognized the potential in the model with the Keystone share price increasing 201 per cent. in the 3 years since its listing on AIM and is now valued at a significant premium to its listed peers. Traditional firms looking for equity investment will now be benchmarked against such performance. They will also need to consider acquisitive growth strategies and how to onboard teams without paying out goodwill.

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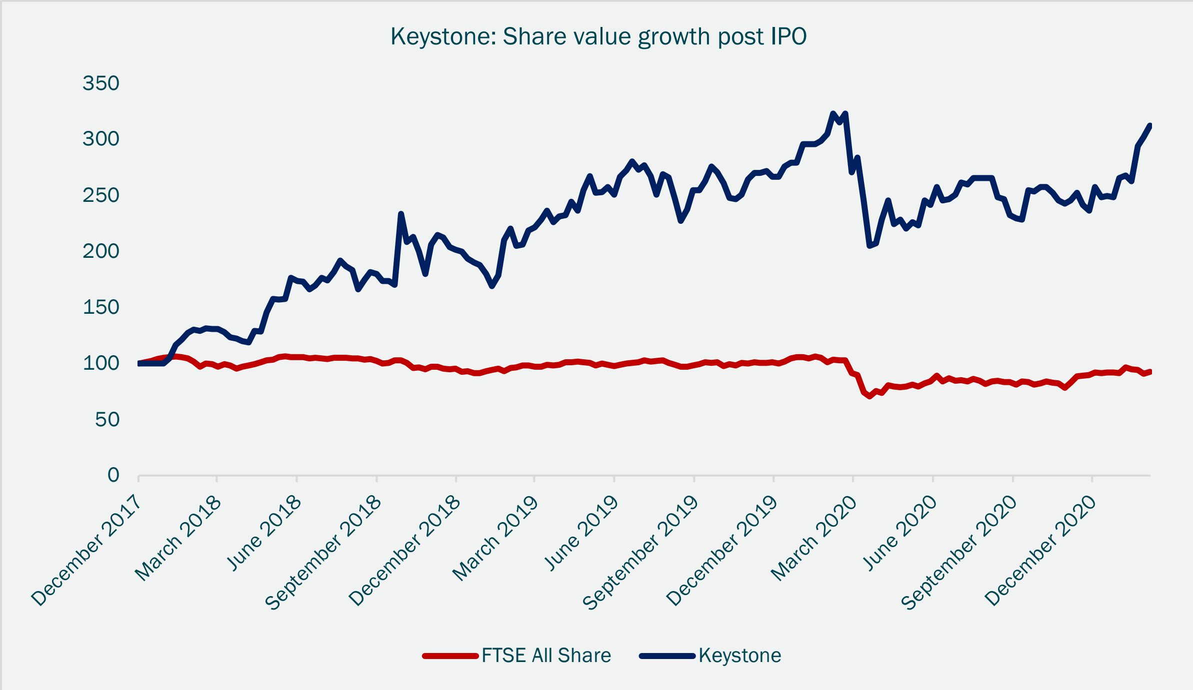


Source: Arden Research

While the consultancy model has gained acceptance from financial investors, it is the operating model that has progressed most from outsider to mainstream. Areas where consultancy firms were originally derided including the implementation of sophisticated practice management systems, a preference for remote / home working and a focus on "self-service" by efficient fee earners and reducing required support staff, are increasingly a competitive advantage. Traditional firms will not be able to compete without significant investment to improve cost efficiency. All legal firms are now facing pressure to invest in IT infrastructure and reduce back office costs to optimise client-focused delivery. By design, consultancy firms have higher quality infrastructure for the management and delivery of legal services. The Covid pandemic has only increased pressure for investment all while most firms are facing historic lows in available cash with partners generally reluctant to commit additional capital, particularly when also faced with reduced or restricted drawings. Similarly, the rapid adoption of home working has accelerated the appeal of "officeless" legal advice, with a recent survey by technology firm Atlas Cloud highlighting that almost 67 per cent. of lawyers hoping for a hybrid work model, while 22 per cent. are hoping to work from home full time.

High street and smaller mid-market firms will become squeezed between fast growing acquirors and the consultancy model. The option of being a small local player may only become available on the consultants' model. Upcoming generations of lawyers are increasingly itinerant and equity partnership is an increasingly unappealing goal. The ability to manage work/life balance and maximise earnings without partnership capital contributions is a strong factor in the growth of legal consultancy, especially as more and more lawyers are voting with their feet.

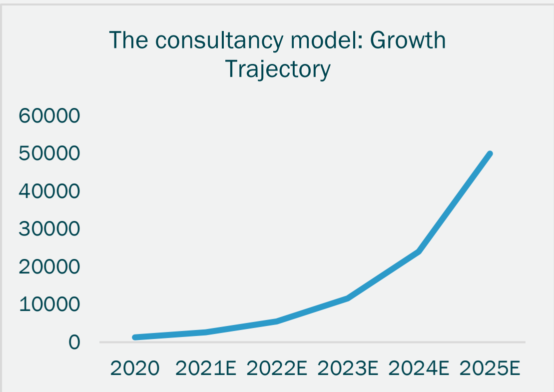
The smaller and mid-market corporate (those outside of the top 100 firms by revenue) and High Street firms are predominantly regionally based, and while this market is large, it is also fragmented, with total revenues of £9bn and an average firm size of 11 lawyers.

The operating model of consultancy led firms has led to a number of competitive advantages over traditional law firms.

SMALLER AND MID-MARKET MARKET SIZE – REVENUES BY REGION

Source: Knights 2020 Half Year Investor Presentation

However, despite recent rapid growth, the consultancy model represents a small fraction of the total legal market. The UK legal market is worth an estimated £37 billion of which £20 billion is outside of the Magic / Silver Circle. By Arden estimates, consultants represent less than one per cent. of the market by value and a similarly small percentage of the c.153,000 lawyers practising in England and Wales. Therefore, there remains still significant potential for growth, which Arden predicts will be in excess of 100 per cent. per annum, culminating in approximately a third of all lawyers who could be working under the Consultants' banner in 5 years.



Source: Arden Research

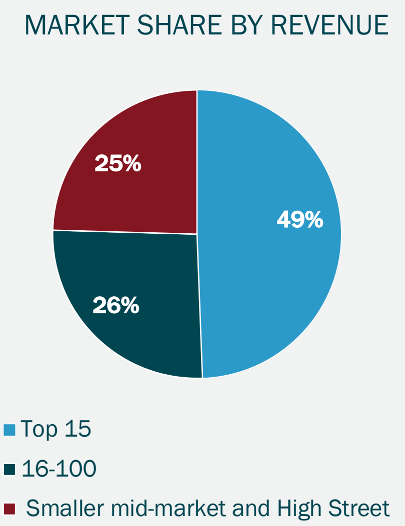
This analysis is based on growth trends that Arden has observed, but also through the analysis of competitive forces and the pandemic has also proven that remote working is now an employment necessity for both for firms and individual lawyers.

As market consolidation continues, consultants are in "pole position". Based on average revenues of £0.74 million for firms outside the Top 200, with 3,000 firms set to merge or close, the total acquisition cost for consolidators could be in excess of £2.6 billion. Even with distressed firms proving cheaper buys, firms seeking to grow through acquisition will likely face further transaction costs of between £50–100k taking professional advisors and due diligence into account, adding a further £175 – 350 million of expenses on top. Beyond the cost of acquisition, consolidators will also face challenges and forced capital spend on integrating small law firms and their legacy systems, particularly where IT investment has been lacklustre, and also take into consideration any restructuring costs that may be involved (redundancy pay, existing office leases of the target etc.). With over £1 billion of cost, this raises a question as to whether smaller firms, particularly those at the lower end of the spectrum, are worth acquiring, when costs may outweigh benefits, especially in an equity partnership model where the revenue acquired actually decreases profit per equity partner, rather than enhancing it.

In contrast, Consultants are easily able to integrate multiple lawyers from small firms as they'd like, with minimal additional capital expenditure required. Consultants offer small partnerships and individual lawyers an attractive alternative, particularly for junior lawyers and associates who no longer want equity. Smaller firms can just practice the law with clients they have long-established relationships with, without having to worry about fixed costs, administration and IT systems, all of which are provided by the Consultant model, for a higher level of remuneration, compared to their existing situation.

Fragmented Market - space to grow

The UK smaller mid-market legal sector remains exceptionally fragmented. There are over 10,000 law firms operating in the UK with close to a third of these firms having revenue of £5 million or less.



Source: Arden Research, the CityUK and the Lawyer

These firms have long been squeezed as the market has evolved with long term questions on how smaller firms would be able to secure succession and investment given cost margins pressures (PII and IT) in the face of regulatory changes and emerging 'new law' models and clients demanding better value.

While traditional firms have grappled with legacy cost structures, consultancy firms have been able to leverage agile business models to secure growth and offer greater economic transparency to lawyers. Traditional firms are now facing a perfect storm of years of under-investment in IT, an ageing equity Partner group and limited and reducing capital reserves, as successors cannot be found. Covid, with its seismic impact on firm financial health and changes in working patterns, could prove to be the catalyst that reshapes the mid-market in only a few years. It has been suggested that up to 30 per cent. of all firms could be forced to close or merge in the near term.

In Arden's view the consultancy model will play the major role in consolidating the 9,800 High Street / small regional firms. It is in the perfect position to recruit lawyers directly, without the costs and risks of M&A.

Consultant law firms are disrupting the legal services market in much the same way as FTSE100 Wealth Management giant St. James's Place did their sector.

The Customerisation of Law

The consultants are also perfectly placed to harness the significant "unmet" legal demand from consumers and have the systems necessary to cross-sell products with cost-efficient delivery. Evidence from the Legal Services Board highlighted that c.3.6 million adults have an unmet legal need involving a dispute every year, while 50 per cent. of small businesses are forced to handle legal issues alone. A large factor in these decisions is cost, with only 1 in 10 viewing lawyers as cost effective. According to Unbiased.com, in the case of personal injury or general litigation, a lawyer can cost between £100 – 300 on average. If we assume that £200 is the average figure for a case and this level of charging persists, then the annual revenue that has not yet been captured is approximately £720 million.

Taylor Rose is one of a handful of law firms that is consistently investing in its platform, to help maintain its market-leading presence and remains well placed to take significant advantage of the opportunity in this space, with a natural ability to cross sell cost efficiently. In addressing this unmet need, traditional High Street firms are ill-equipped. However, the centralised business development and sophisticated IT systems give consultancy firms an important advantage at targeting the new markets on the High Street. This includes maximising the reach of marketing and efficient client capture to convert leads, in effect, targeting and selling what the customer wants and not simply what the lawyers "do". Customerisation of Firms is the new battleground, especially for smaller firms and it is one that Consultants are well placed to win.

In the early part of this century, we saw a similar shift in the Opticians market, where customerisation played a key role in that market's consolidation. Deregulation of the industry allowed opticians to advertise their services, which provided customers with better choice and more cost efficient access to services. By 2007, that market was 70 per cent. of market share and was dominated by four national chains, which used a franchise model to consolidate the smaller practices. Today, c.66 per cent. of the market is under the control of the three national chains of Specsavers, Boots (which merged with Dolland & Aitchison) and Vision Express. It is easy to therefore see how Consultants are in primary position to gain traction and momentum. With significant unmet legal demand in the commercial space, and with corporates seeking high-quality services and a lower cost, Consultants are already proving their ability to cater to both sets of customer types. They provide services that consumers want; not simply services that lawyers 'do'.

New Models Established

Having established a clear market presence, the legal consultancy model is poised to capitalise on the disruption caused by Covid to accelerate growth. Crucially, Covid has removed one of the last barriers to growth as the office status quo has been broken. Consultants in the dispersed model are required to largely home-work and for many this required a leap of faith. A year of lockdowns have forced lawyers to 'trial' working at home. Taylor Rose, which has 167 lawyers and an equal number of support staff working under its consultancy umbrella, has commented that following lock down it has seen a significant increase in enquiries from lawyers with up to 20 new consultants joining the platform each month, at a tremendous compound annual growth rate of 135 per cent from 2014 - 2021. The new law models have built the platform and now the lawyers are responding. Not only are the new law models actively gaining market share, but they are increasingly being selective about recruitment.

They have proven their ability to attract and retain quality legal talent, increasing their presence both locally and nationally, simultaneously displacing traditional law firms and the High Street.

The operating model of consultancy led firms has led to a number of competitive advantages over traditional law firms. Improved practice and risk management systems, required for managing a dispersed workforce, keep regulatory costs low and maintain efficient structures focused on fee earners rather than large support costs. The lack of large office spaces further reduces fixed costs and combined allow consultant models to offer attractive remuneration structures while continuing to provide a high-quality service at lower rates.

For millennial generation lawyers this could be the route to partner level earnings without the capital commitment and risk. Far from being a collective of individuals with little loyalty internally or brand recognition externally the new consultancy models are now part of the mainstream. To prove this point Keystone was announced law firm of the year at The Lawyer Awards 2020 and its "model has been vindicated in spades". In the eyes of lawyers and customers they are now a proven option for aspiring lawyers and discerning clients.

Finally, the consultant models' low cost of growth provides an inherent advantage against even some of the most successful consolidators like Knights; a low cost of growth. Growth under the consultancy model is achieved by the recruitment of additional lawyers with little additional cost for each lawyer as systems scale. There is also no historical regulatory risk that may be unquantifiable i.e. Successor Practice. In contrast the corporatized firms, while able to grow through lateral hires, have typically grown through merger and acquisition. Such transactions require significantly higher initial outlay (consideration) and restructuring costs. As successor practices the newly merged firm carries the regulatory past of both firms going forward.

In the changing mid-market, the winning models will be:

- **Consultancy:** Rapid growth from onboarding of new consultants and characterised by a sophisticated IT platform and low central costs, such as Keystone, can work alongside an employed model i.e. Taylor Rose.

- **Efficient Corporate Consolidators:** Practiced consolidators with a well-defined M&A strategy and an ability to execute this strategy in-house against clear parameters. Knights ability to issue listed equity in consideration gives it a further advantage as a consolidator model. They will have a clear list of targets and will not pay over the odds. Increasingly they will also focus on lateral hires to leverage their platforms.

- **Hub and Spoke:** A strategy articulated by Shakespeare Martineau but still to be tested whereby central costs and infrastructure are consolidated around a core hub allowing practices to join and benefit from scale and shared costs but retain their identity. This may be a particularly attractive model to larger regional mid-market firms who have a strong identity, but longer term will face a strategic threat if they fail to invest in the New Law market.

All these models, or mixtures of them, generate efficiency from scale and investment. They also have the ability to invest in central management and brands that will enhance their "customerisation", gearing themselves up to provide competitively priced services that the client wants, even if not pure legal services. Faced with this competition, the traditional small partnership will become a rare sight in five years.

Conclusion

Consultant law firms are disrupting the legal services market in much the same way as FTSE100 Wealth Management giant St. James's Place (SJP) did their sector. SJP was the second fastest entrant in to the FTSE100 at the time and used a scalable platform to draw in over 4,000 financial advisers, roughly 12 per cent. of the entire UK market, all of whom are self-employed. The parallels are striking and with technology vastly evolved now relative to 2014 when SJP entered the FTSE100, it is easy to see why the growth opportunity is such an exciting prospect.

The legal space is also beginning to mirror the changes that characterised the UK opticians market. A regulatory shift allowed opticians to advertise their services and, by opening up, 66 per cent. of the market was consolidated by 3 firms, all of whom run franchise models. The comparisons with the current opportunity for consultant firms are plain to see, particularly in the context of the potential market size and share that is winnable, further highlighting why 50,000 consultant lawyers by 2026 is not a stretch of the imagination.

With a significant unrealised market opportunity, an ever increasing market share and an attractive and cost-effective recruitment proposition, it is easy to see why there is such a strong investment case for public and private investors. As 2021 evolves, we expect that the consultancy model will go from strength to strength and growth rates to continue to accelerate. Maybe the first FTSE 100 law firm will be a consultant model!

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