2013 MHA Professional Practices Benchmarking

Report

MHA Professional Practices

Summer 2013

Professional Practices Benchmarking Review

Karen Hain, MHA Head of Professional Practices, Partner at MHA member firm Moore and Smalley LLP

Welcome to our first MHA benchmarking review looking at the results of legal practices for 2012. It has been another year of change for the legal sector, with the marketplace opening up to competition from ABSs, added compliance for the COLP and COFA and additional pressure on fees under legal aid and personal injury law.

Our national accountancy association, MHA, enables each of our member firms, as sector specialists, to understand the regional impact that we are seeing for our legal sector clients and discuss these from a national perspective. We are able to compare different sized firms across different legal sectors and across the country, so that we are able to truly add value to our client's experience.

We have covered a brief selection of benchmarking topics that we know are important to legal firms. Income is by far the most discussed key performance indicator, and we focus on what we are seeing from the national results. We then pick up the profitability ratios, with their desirable outcomes. Employment costs are frequently reviewed and so we have given some thought to these national trends and finally, we have considered lockup, which is of course a critical part of working capital management.

The ratios that we discuss are generated by each of our regional members, and I would like to thank my Professional Practices sector group for their input and contribution.

I hope you find this report interesting and useful when reviewing your own financial ratios.

Income

Written by Seamus Gates, MHA member firm, Broomfield & Alexander

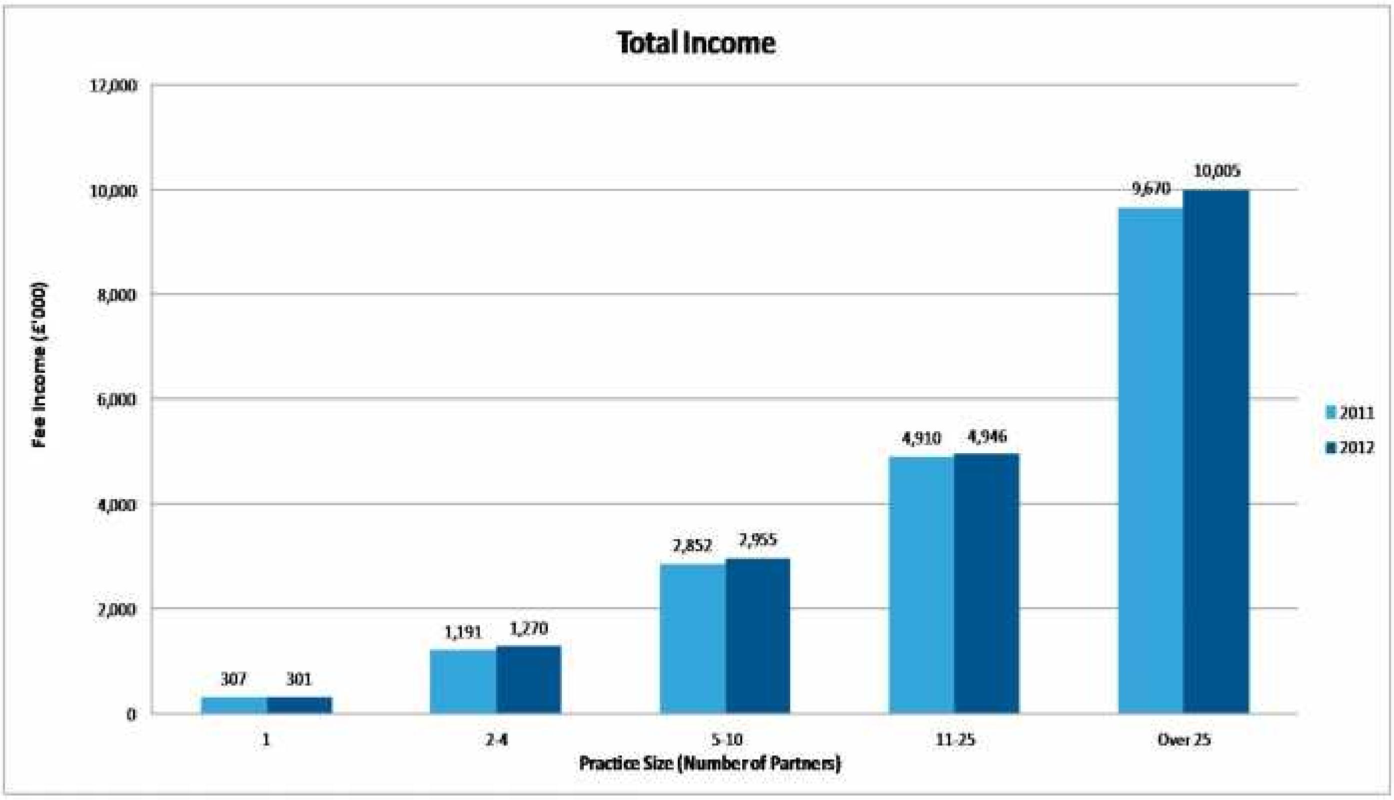
The income of legal firms has seen limited growth in recent years. This is primarily as a consequence of the following factors:-

- The impact of the recession with a reduced number of corporate and property based transactions;
- Reduction in income derived from client monies held due to interest rates being so low; and
- Changes in the structure of legal aid and personal injury compensation schemes.

Many of these factors remain with the continued impact of the recession, low interest rates and further legislative changes ahead.

As a consequence, small to medium sized legal practices have been under more financial strain than they have been for many years. Indeed many firms relying purely on transactional fees or legal aid have been under particular pressure.

The MHA client base demonstrates that practices have seen little growth in overall fee income with growth rates of between 1 - 5% and an average of 1 - 2% between 2011 and 2012.



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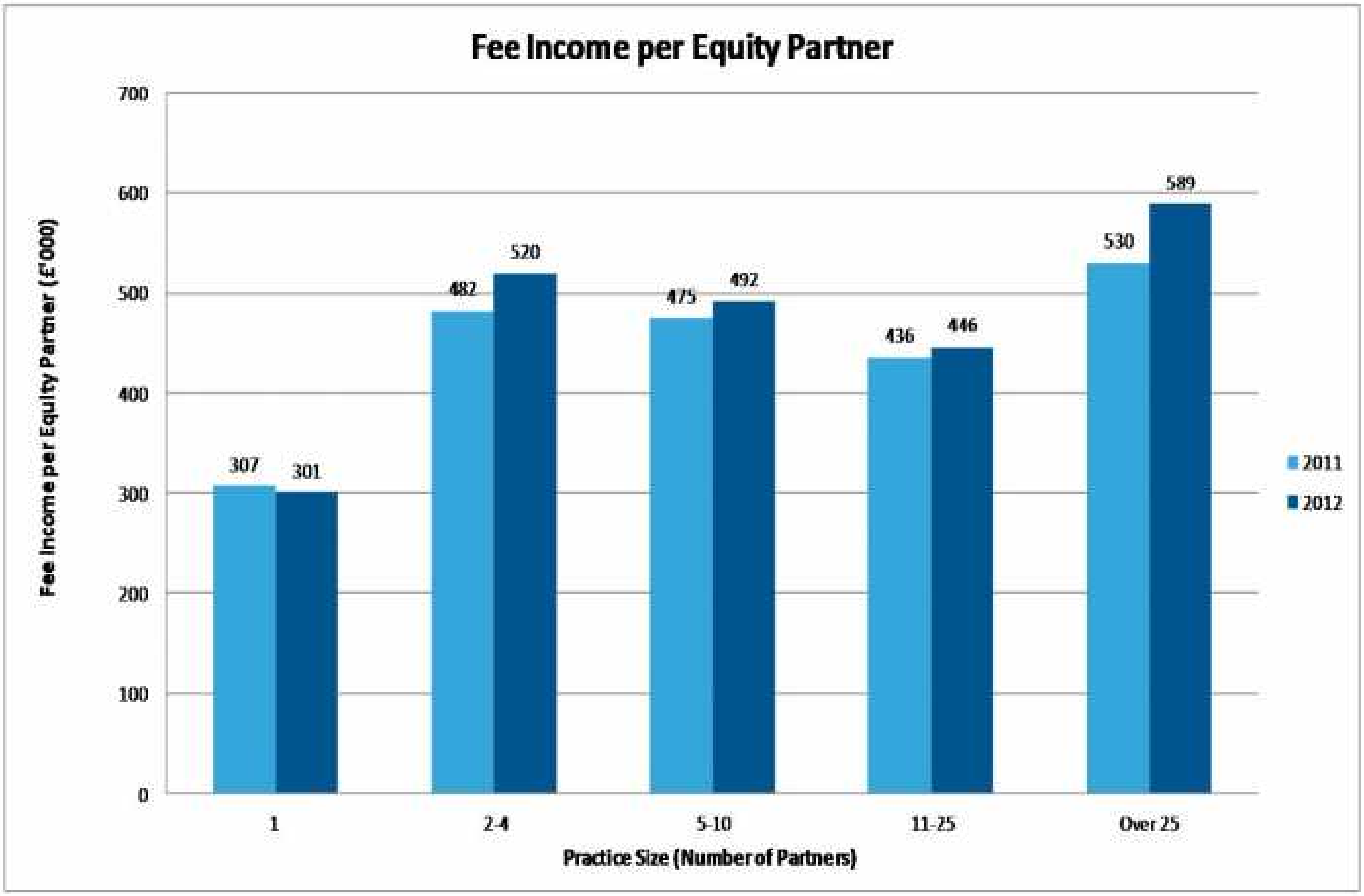


Fee income per equity partner ranges between £300,000 and £590,000 with an average of £400,000 across the UK.

Typically, the larger firms have higher fees per equity partner due to their heavier reliance on more fee earners, with sole practitioners typically achieving roughly half of this fee income being £300,000 per equity partner.

The continued lack of significant organic growth in recent years has led to a greater tendency towards mergers and acquisitions of law firms.

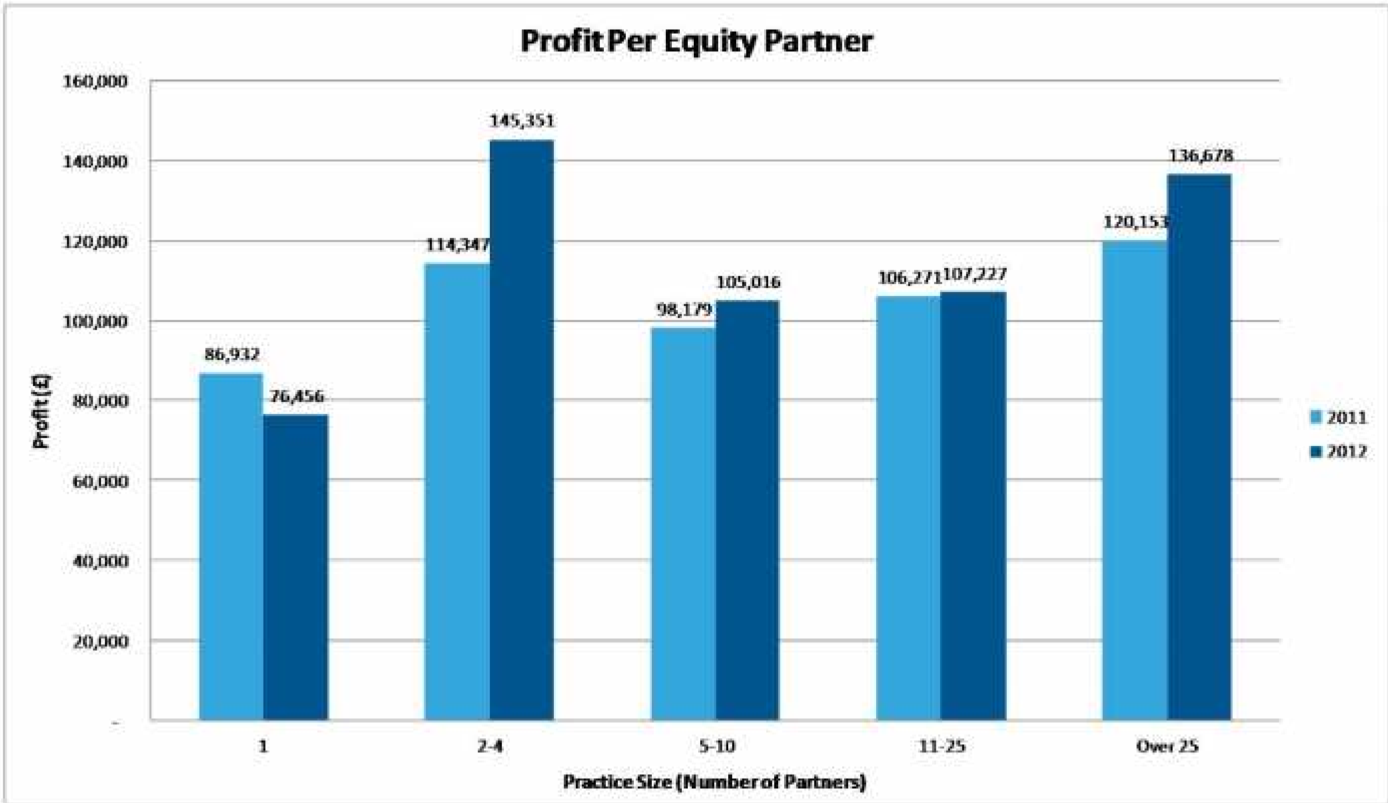
We at MHA are anticipating this trend to continue and would expect to see a greater number of mergers in the legal sector in the coming years.

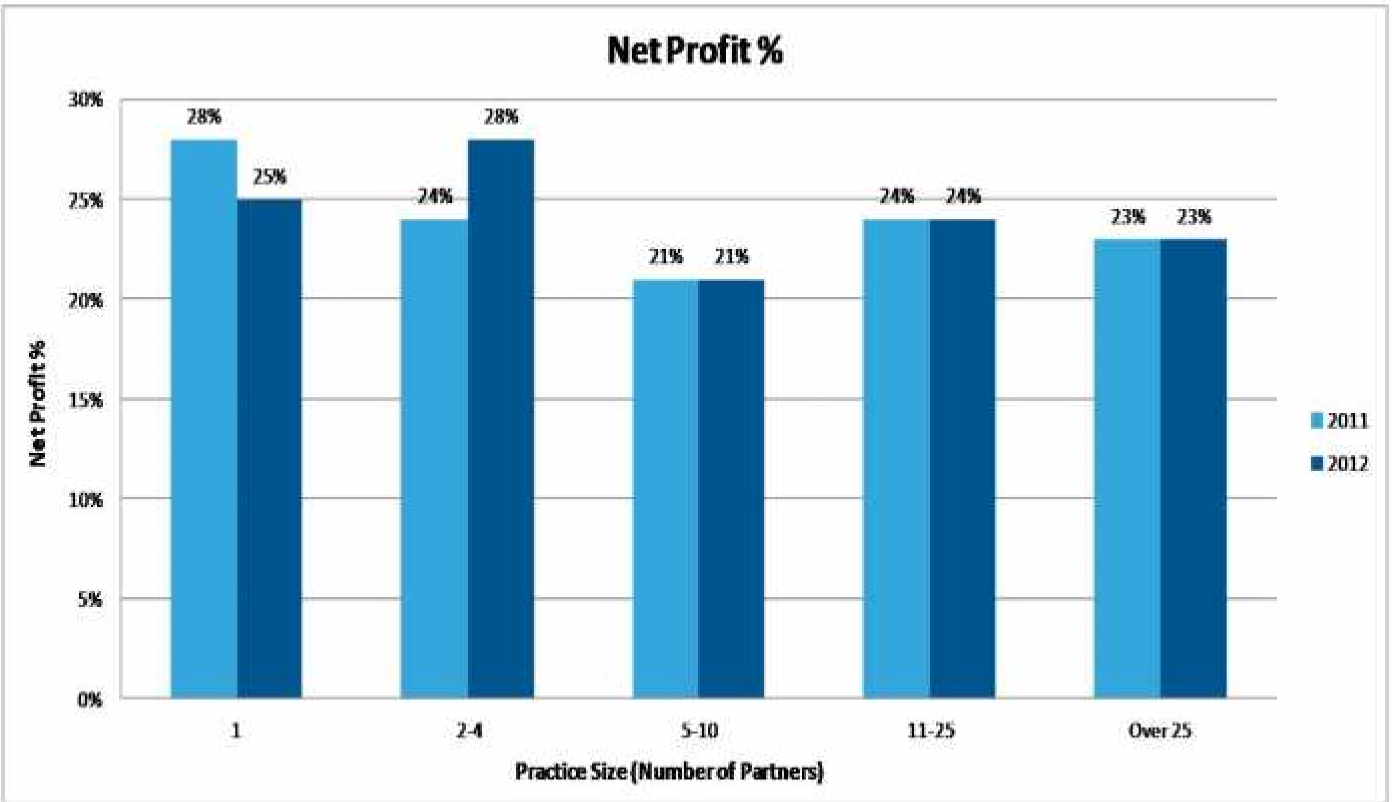
Profitability

Written by Harmy Gill, MHA member firm, MHA Macintyre Hudson

Profit per Equity Partner

- It will not come as a surprise that our survey found that Profit per Equity Partner (PEP) statistics overall mirrored fee income per equity partner. PEP statistics will obviously vary greatly amongst firms due to both efficiency and concentration of equity however, PEP remains an important KPI to use in trend analysis. PEP was seen to fall for sole practitioners, but increased across all other practices by between 1% and 27%.
- On average across the UK, equity partner returns increased by 8.5% over a meagre 2011 to £114,145.
- The strongest improvement was in the 2 - 4 partner practices and the over 25 partner firms which improved average PEP by 27.1% and 13.8% to £145,351 and £136,678 per partner respectively, compared to 2011.
- Understandably, the greatest pressure was on sole practitioners whose profit shrunk by 12.17% to an average of £76,456 as the continuing burden of regulation fell disproportionately on their shoulders.





Net Profit Percentage

- In terms of average Net Profit Percentage (NP%) the above translated to a 3 basis point reduction for sole practitioners moving down, on average from 28% to 25% net profit. Across other practices NP% remained unchanged at 21% / 24% / 23% for 5 - 10 / 11 - 25 / over 25 partner firms. The only firms to ‘buck’ this trend were the 2 - 4 partner firms where average NP% increased from 24% to 28%. This suggests that only firms of this size were ‘agile’ enough to turn the increased fee income streams into increased bottom line profitability.
- Looking at the employment costs benchmarking (page 7 and 8), it would appear to be the case that firms of this size were the most successful at managing employment costs down significantly as a percentage of fee income from 65% to 60%.

PII Fees

- PII costs as a percentage of fees, held stable at 3.2% on average, with the larger firms obtaining an advantage of a 1% reduction to 2%, with those at the smaller end of the market making up the difference. Sole practitioners on average paid 5% of their fees (same as 2011) but the 2 - 4 partner firms bore the brunt of the larger firms' savings, increasing their average cost from 2% to 3% of fees.

Marketing costs

- Marketing costs clearly benefit from 'scalability' and our survey reaffirmed the 'higher' cost burden on sole practitioners where marketing costs remained at 5% of fee income. For 2 - 4 partner firms this drops to and remains consistent at 1% of fee income and then 5 - 10 / 11 - 25 / over 25 partner practices appear to plateau out at 2% of fee income for 2012 as in 2011.

Whilst trying to achieve improved profitability in a "flat" economic climate will remain a challenge for all professional practices, we at MHA believe the legal sector will continue to remain at a distinct disadvantage due to the increased competition resulting from deregulation, added compliance burdens and sector specific issues (relating to legal aid, PI referral fees and a reduction in PII providers, amongst others).

Therefore, looking for continued improvement in the management of lock up, employment costs and fee income growth at per partner level must remain the focus for law firms. The consideration of mergers as a means to an end will likely become more pronounced.

Employment

Written by Simon Tombs, MHA member firm, Monahans

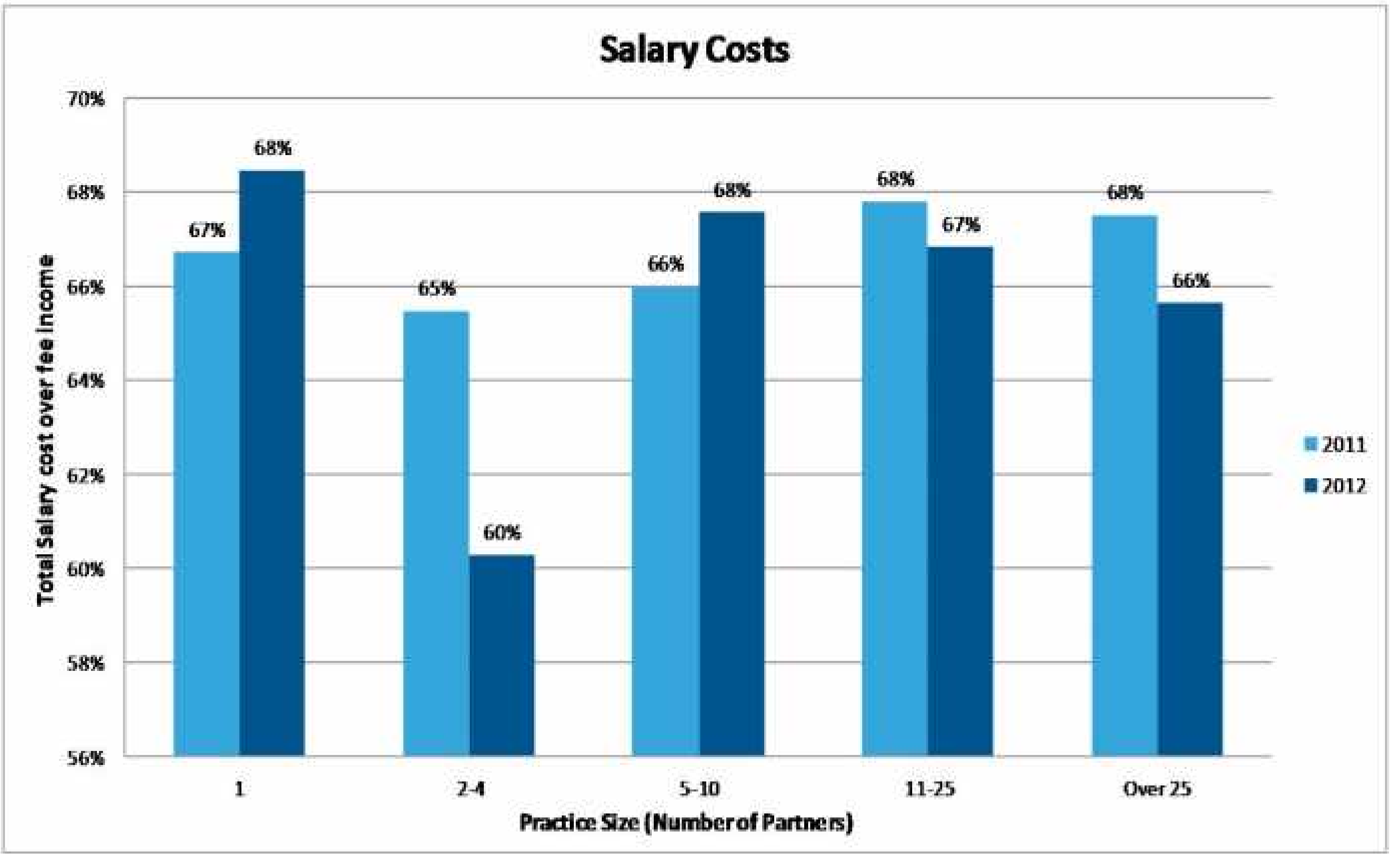
This measure simply compares the major cost of any solicitor practice's employment costs against fees. In order to give this measure meaningful management perspective, equity partners have been included using a notional salary of £100,000 per partner.

During recent years many firms have undergone restructuring of staff levels as they have needed to cut costs as a consequence of the recession.

Our survey covers the whole of the UK and a variety of different sized practices. The results vary little between most of the regions, with the South East, South West, London, Eastern and Scotland all having employment to fee ratios of between 67% and 72%, with all but the South East having reduced the percentage compared to the prior year. This is perhaps not surprising as cost cutting and efficiency measures previously taken come in to force.

If we look at firms grouped by size, it is interesting to note all size firms from sole practitioners to 25 plus partners, with the exception of 2 - 4 partner firms fall, in the range 66% - 68%. 2 - 4 partner firms however show a large improvement from 65% in the prior year to 60% in the current year, perhaps demonstrating that they have been best able to adapt and react swiftly to the changing climate.

This measure is key for firms to focus on as they seek to restore or improve profitability. A good percentage to aim at, including partners notional salaries, is 60% of fees or less.



* Note this includes equity Partners at a notional £100k salary cost

It should be remembered that while firms have tried to improve results and consequently this ratio by cutting salary costs this is very much only part of the answer, other areas to consider are:

- Improving the way work is actually processed, this might be reviewing systems and streamlining or investing in IT to speed up processing.
- Delegating appropriate work to lower level / less qualified fee earners.
- Outsourcing.

Lockup

Written by Charlie Eve, MHA member firm Carpenter Box

Control of lockup (unbilled work in progress and unpaid debtors) is something that firms cannot afford to ignore. In the current climate we would be expecting firms to be focusing on working capital management by collecting debts earlier and billing WIP as promptly as possible. Increasing lockup is usually funded by a combination of bank finance and by partners contributing more capital or restricting their drawings, neither of which is easy to do as the financial climate continues to be challenging.

It is, therefore, encouraging that the average lockup days of over 100 firms included in the survey has reduced by 6 days when comparing 2011 to 2012. The more worrying statistic is that the average lockup days amounted to 127. This means that, on average, it takes over four months from doing the work to converting it into cash. The worst performing region had a staggering 162 days of lockup meaning that it takes over five months from the work commencing to the point of receipt of payment. A reasonable target bench mark for lockup days would be 110 days. On average this would be a reduction of 17 days lockup.

To put this 17 days into some monetary perspective, if firm ABC had a turnover of £2million and lockup of £696,000 then its lockup days would be 127. If lockup was reduced by 17 days, cash flow would improve by £93,000.

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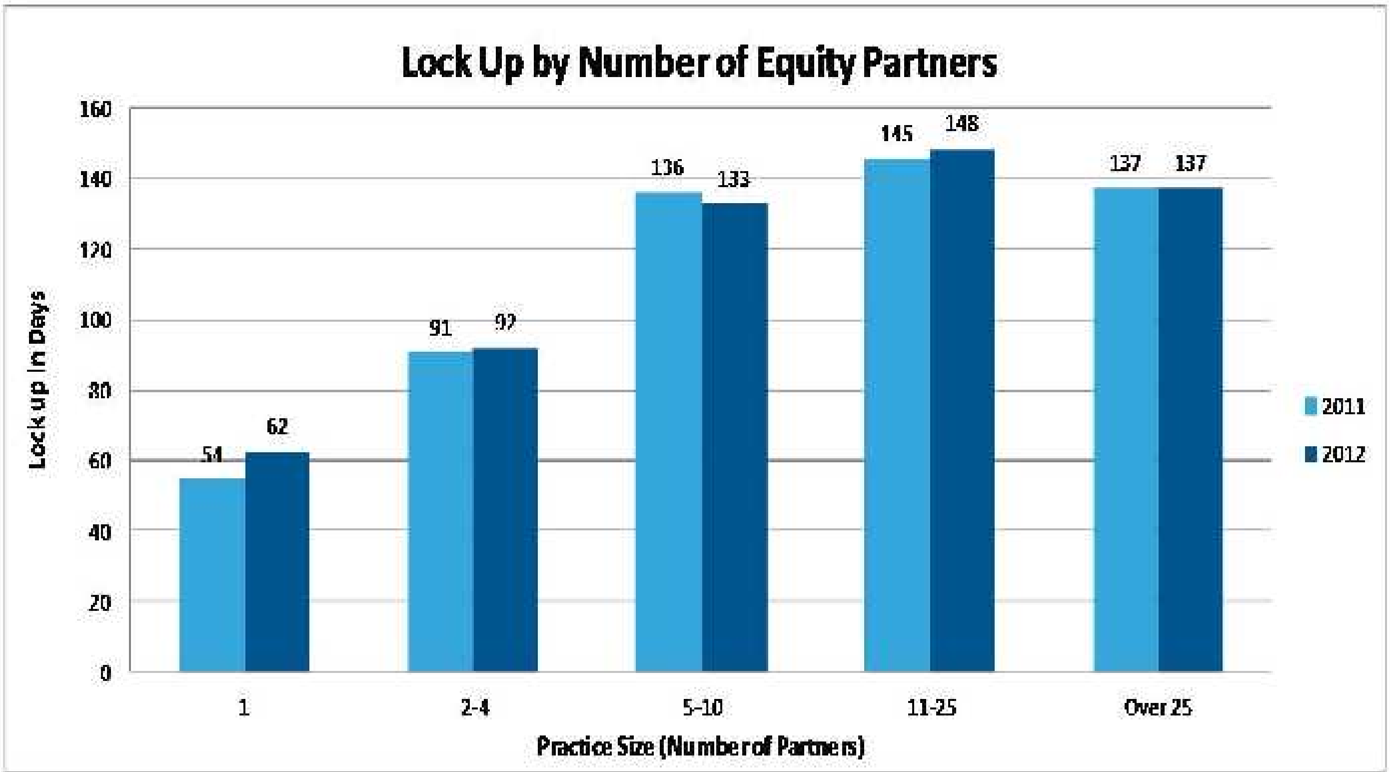
When reviewing lockup by size of firm, rather than by region, the best performing firms were the sole practitioners with total lockup at a very encouraging 62 days. The worst performing firms were the firms with 11 - 25 equity partners where the lock up totalled, on average, 148 days.

Lockup, generally, has an impact on the size of the equity partners current and capital accounts. Fluctuations in these balances, though, are not always a good guide to changes in working capital as partners could also be funding acquisitions, property and other fixed assets through their current and capital accounts. It is worth mentioning, though that in our survey a partner in a firm of 2 - 4 equity partners would be expected to provide finance to the practice at an average balance of £177,000. This is £74,000 higher than all the other firm sizes.

We at MHA feel that there will be increasing pressure on lockup in the years to come. There are many techniques that are available to assist with reducing lockup. It will be partly the role of the COFA and other valued advisors to ensure that lockup does not become a serious problem.



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Concluding Statement:

Karen Hain, MHA Head of Professional Practices

So what questions are you already asking yourself?
Where does my firm fit into the benchmarking results? Are you better than you thought? Or do you need to act now to improve? Your regional MHA member firm will have a lot more financial data that will assist you to benchmark your firm. You should use this to plan for your firm's 2013 performance, as it is likely to be another tough year for the sector.

And what other thoughts arise? Around one third of legal practices are considering a merger in the near future. As can be seen by the ratios, there are economies of scale to be generated in a larger practice.

More firms are also considering bringing in non-lawyer owners under the ABS regulations. Many of these individuals are based in finance, marketing or HR with the understanding that retaining key staff gives a firm a strategic advantage.

Whatever your plans for 2013, please do not hesitate to contact your local MHA member firm for advice and assistance.

About MHA:

MHA is a UK wide association of progressive and respected accountancy and business advisory firms. Accountancy firms are invited to join MHA only when they meet the standards and culture of the organisation, which includes a commitment to helping our clients to succeed by supporting them above and beyond what might normally be expected from an adviser.

Each MHA firm offers a broad range of services including accountancy, tax and corporate finance as well as sector specialisms. They work collaboratively under the MHA banner when clients have multiple locations or specific national needs. MHA firms are characterised by their strong regional reputation for providing outstanding accountancy and business advice to entrepreneurial businesses.

With 45 nationwide offices MHA is able to balance national access and capability with the local insight and perspective that individual member firms offer their clients. As well as our national presence MHA is a member of Morison International, giving access to a global network of trusted advisers.

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Thank you

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