

## Merger Economics

© Zeughauser Group, LLC 2008

(first published in *ZGuide to Leading Law Firms: Zeughauser Group's 2008 Pocket Guide to The American Lawyer Rankings*, August 2008)

Many factors drive merger decisions. But, perhaps the most material factor, after irreconcilable conflicts, is the dilution of profitability or financial performance generally. In assessing merger candidates, firms often take only a quick look at public and private data about profits per equity partner (PPEP), revenue per lawyer (RPL), compensation all partners (CAP), value per lawyer (VPL) to make an initial thumbs up or down decision on merger candidates. Many firms apply a simple “no dilution” criteria, meaning that they won’t merge with a firm of lesser PPP.

Firms that apply this “no dilution” criteria (or even no “significant dilution” criteria, the commonly referred to as “within spitting distance” test) ignore the dilutive effect of growing by lateral acquisitions. In doing so, they often pass on attractive growth solutions.

The alternative to a merger is typically growing by lateral hire one or two at a time, or by acquiring groups when they are available, which is rare. Growing by lateral and group acquisitions is an expensive and risky proposition. Expensive because a lateral’s receivables belong to their prior firm. When a firm brings on a lateral, there is typically a four month gap between the date the lateral begins taking a draw and the date on which the firm begins collecting on the receivables generated by the lateral at a new firm. For a lateral coming in at the average AmLaw 100 draw of approximately \$1,200,000, this costs most firms, depending on margin, about \$150,000. On top of that, if the firm pays a search fee in the amount of one-third of first year’s draw, the cost goes up by \$400,000, to a total of \$550,000.

There are other costs of acquiring laterals, too. Anecdotally, firm chairs report that about 40% of lateral partners don’t pan out (the percentage on lateral associates run substantially higher) either because their book of business, the quality of their work product or the level of service they provide aren’t up to snuff. And, there is the opportunity cost involved in the extraordinary amount of time spent recruiting a lateral,

typically by firm management but also the time of partners involved in vetting the candidate; time that could be spent pursuing other strategic objectives.

Achieving critical mass in a number of markets, whether defined by geography, industry or practice area, and particularly if the growth is in expensive markets (major financial centers or hot practice areas or industries), often involves recruiting hundreds of lawyers. In the simple economic model described above, every 100 laterals costs the growing firm \$55,000,000 paid out of cash flow. If this growth is spread evenly over five years (twenty laterals per year), the effect on profits per partner in a 200 partner firm would be to lower PPP by \$55,000, during the first year. The dilution on PPP would decline gradually over the five years as the number of equity partners grew so that, for instance, all things being equal the cost in the second year would be approximately \$50,000.

In a merger, there are no lost receivables; both firms' receivables become the property of the merged firms. There is no gap in collecting receivables, nor are there any lost receivables, other than ordinary write-offs. And, merger fees and other costs remain modest compared to search firm fees.

Of course, this is a simple economic model. But the model makes enough sense to drive home the dilutive effect of growing by lateral acquisition. Using this model, a firm ten percent less profitable than another firm would have no dilutive effect on the profitability of the better performing firm.

There are other economic reasons that make a merger attractive. If the underperforming firm has strong talent and a strong reputation for quality and service, but is in a lower rate market, there will likely be long-term opportunities to raise rates to a par with the firm operating in the higher rate market. And, the reputation for quality and service can go a long way to letting management of the other firm "sleep at night," knowing that merging with a high quality firm is less likely to yield a rogue, "high-liability" partner than acquiring laterals one and two at a time.

One can draw several conclusions from this analysis. First, growing by merger can be far less dilutive than growing by picking off even quality laterals one and two at a time. In a consolidating market, building market share quickly is important. Industry data indicates that larger quality firms are growing market share disproportionately faster than other firms. As a group, they are also outperforming the market in growing RPL, CAP and VPL. When compounding is taken into effect, it becomes virtually impossible for the smaller firms, who are losing market share to the stronger large firms, to retain market share, much less build it.

Second, the market should ultimately evolve to a point that smaller successful firms willing to be acquired should like participate in some of the savings that arise through the efficiency of a merger should they choose to be acquired in exchange for giving up their prized independence. This participation will likely be paid in the form of a premium.

Third, there are a limited number of plausible, attractive merger candidates for any given firm. If a merger strategy indeed makes sense for achieving growth, then the most gain is likely achieved by finding the right partner sooner, rather than later on the assumption that the attractive merger candidates will disappear most quickly.<sup>1</sup> A corollary to this relates to the second conclusion above. It might make sense to disproportionately share the merger largess (i.e., savings achieved by the merger) with the partners of a sought after firm as an enticement to merge.

Fourth, the task of building partnership consensus around a merger strategy can be greatly enhanced by dispelling the common wisdom around the dilutive effect of mergers. If a firm's leadership is going to lead successful growth with a merger, then the leadership must educate the partners on the economics of growth by lateral acquisition and by merger.

Finally, evaluating the attractiveness and success of a merger is a long term proposition. Mergers are attractive because they allow firms to build market share quickly and less expensively than by acquiring laterals. Market share ultimately leads to pricing power.

We are witnessing an historic consolidation among the top 350 or so grossing firms in the world. It is a battle over the long-term sustainability of practices, and it is being played out first over market share, positioning and branding as a prelude ultimately to increased pricing power, particularly towards and at the high-end of the global market for legal services. Combining attractive brands in important markets should be viewed as a strategic investment in positioning, brand enhancement and market share. Higher grossing firms ultimately have more muscle, more money to invest and greater resources to bring to bear on client opportunities, but that doesn't necessarily translate into increased short-term profitability. Balancing the cost of growth against maintaining and growing profitability is a difficult task. Not getting the analysis right, in the end, is very expensive.

---

<sup>1</sup> None of this is to suggest that all firms should or must merge. We indeed continue to believe that there will be strong, differentiated market positions for firms that desire to remain independent.