Fit for purpose

In the current flurry of merger activity, firms risk either feeling pressured into making a poor decision, or losing out by not being prepared to compromise. ***Andrew Hedley*** *shows you how to walk the path in between and make the best choice possible for your firm*

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The legal services market is witnessing an unprecedented level of merger activity. The legal press is full of news of firms either in discussions or announcing a deal, but there is also a swell of activity behind the scenes of firms just starting to consider the value of merger as a strategy for their firm, or in early discussions with potential merger partners.

So how can firms get from those early stages to concluding not just any deal, but the right deal? The aim is to find the right partner for the individual firm to help it achieve its strategic goals. But this is very challenging. Firms may play 'fantasy football' in private, envisaging the ideal scenario of what the firm wishes to become and the nature of its merger partner, but the reality is that choices in the real world are somewhat more limited, candidates less alluring, and mutual attraction more difficult to find. This article is designed to help provide a framework for firms facing this process.

The article is based on two basic assumptions: that the firm has already decided that a merger, acquisition or sale provides the best opportunity for it to secure its strategic objectives (whatever those may be); and that both parties have genuine freedom of choice and can walk away from the deal if they choose to (that is, the merger is not a distressed purchase or 'fire sale'). There will, of course, be firms whose business plans are founded on the cheap acquisition of failed firms – either through pre-pack arrangements or simply the purchase of the book of business at a discount – and there are a number of effective strategies for such a goal, but these will not be considered here.

The article is also designed to be of interest to both the senior (buyer) and junior (seller) party in the transaction. Historically, 'acquirer' firms have tended to be most active in seeking out opportunities, but current market conditions mean that firms in both categories are exploring options and potential candidate firms. The key characteristic is that a firm is active in seeking a deal; it is the way in which this search is shaped and progressed that is our central concern here.

1 AGREE YOUR STRATEGIC GOAL

Absolute clarity is crucial at the outset of any search for a merger partner. In the simplest of terms: do you know what you are looking for, and how you will know that you've found it?

It should never be forgotten that a merger is, at its simplest, a means of achieving a strategic objective. What this means in practice is that the firm post-merger should be closer to its overall strategic vision than it was pre-merger. While the firm's overall strategy will have identified merger as the best means of achieving this vision, creating a clear picture of the sort of firm that will deliver what is needed requires more work and a detailed appreciation of the dynamics at play.

It is not enough to simply state that a merger must give the firm a presence in location X or strengthen practice area Y or open up further opportunities in sector Z. Any union will have multiple effects, both positive and negative – these need to be examined and their impact understood, and a plan must then be created to maximise opportunity and mitigate threats. It is by developing a rounded view of candidate firms that decisions can be made about which priorities to apply or opportunities to pursue.

2 BUILD A PICTURE OF WHAT YOU NEED TO ACHIEVE IT

Now you know what you want to achieve, you need to decide what the perfect partner who could get you to that goal would look like – but you also need to be realistic about how the actual, real-life options weigh up against that ideal.

Building a comprehensive candidate scorecard can be a useful tool to guide this process. The scorecard presents a picture of the characteristics of the ideal merger partner, based on the firm's strategic objectives, and then each potential real-life partner can be scored against that ideal. This means that initially, developing a scorecard can help to clarify thinking; later, it can provide a means by which candidate firms may be assessed on a like-for-like basis.

There are three stages in creating a scorecard.

First, you need to define the desired end-state. Start by taking the firm's strategic vision and breaking it down into its base components. The aim is to provide a clear understanding of 'what good looks like', from macro issues down to granular detail.

Consider both 'hard' and 'soft' issues. The risk is that we measure the things that are easiest to measure, or those that we have historically considered, rather than those which are strategically significant; firms generally have robust data on and can analyse 'hard' issues like financials, but not 'softer' issues like client satisfaction, culture and brand. The final scorecard should therefore, in addition to detailing, for example, desirable characteristics of practice groups, offices, financials, infrastructure and markets, include issues of culture, values and

key attributes of the firm's brand and market position. For more details on where to look for information, and what information to look for to compile your scorecard, see the box overleaf and the figure below.

Second, you need to conduct a gap analysis by scoring the firm, in its current position, against the desired future end-state.

Finally, you need to abstract the gaps identified to define the shape of the missing piece in the firm's strategic jigsaw – that is, the 'perfect' merger candidate who would close the gaps you identified. This information will form the basis of the final scorecard.

Whether that ideal candidate actually exists in reality is, of course, a different issue, and it is likely that compromise will be needed in the search process. The pragmatic objective is to close a significant number of the gaps through the merger option, rather than all of them. A merger will most likely represent a significant step forward rather than the achievement of the vision in one movement.

Now you have the basis for the scorecard, but there is one final stage. Clearly, not all the desired characteristics of your ideal merger partner are equal, so you now need to allocate an 'importance' weighting to each characteristic in the scorecard.

For instance, one gap identified may be a need for additional strength in a particular practice area, while another could be a new office in a different city, in order to strengthen the firm's overall proposition to its target clients. The first of these, while important, is of a different order of magnitude to the second. There are a number of incremental ways in which a practice area can be strengthened over time (merger being just one), while the options are far fewer when it comes to establishing new offices, and merger is certainly the simplest and fastest. A merger proposal is unlikely to stand or fall on whether or not the candidate satisfies the first gap (for which other options exist), but may well be contingent on its realising the second.

In weighting your scorecard characteristics, you will need to identify the areas of highest importance and those which may be tradeable. Are the showstoppers clear? How much 'fit' is required as a minimum to make a deal workable, and also worthwhile, given the significant cost of pursuing it?

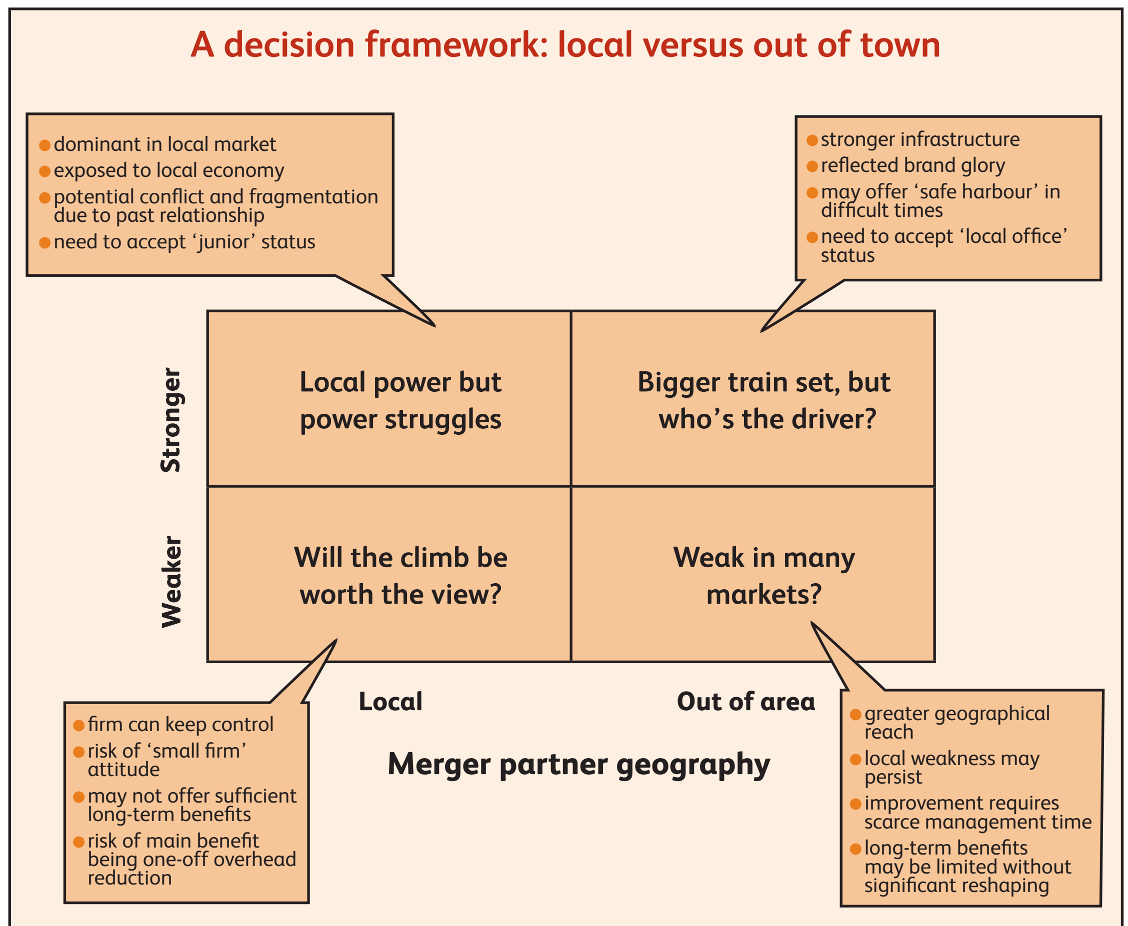
Obviously, there will almost certainly be the need for compromise in assessing any candidate firm. This might include areas of overlap or duplication, capabilities which will still be under strength, assets that will not yet be in place, or client conflicts (real or commercial) which will need to be worked through. A structured approach means that such trade-offs and their inter-relationships can be understood fully, weighed up, and their implications assessed.

Identifying the gaps that will still exist after any merger also informs wider investment decisions: which areas should be reinforced on an ad hoc basis, what further merger activity may be necessary in the fullness of time, and which investments should be pursued immediately.

3 DEFINE THE PARAMETERS OF THE SEARCH

Now you have your scorecard in place to pick between individual firms, but you also need to understand the parameters within which you will search to identify those firms. One way to do this is by using decision frameworks to explore different option permutations. These set out your various alternatives clearly and comprehensively so you can decide between their relative benefits and risks.

Take, for example, a firm looking to consolidate in its own city. It should already have a good knowledge of the potential candidates, since it will have interacted with them for many years. This clearly has its benefits, but also its risks: such historic competitors will often be viewed either under a hyper-critical microscope or through rose-tinted spectacles. The challenge of bringing objectivity to bear can be significant. If, instead, the firm were looking to expand outside its current location, a different set of opportunities and challenges would be brought to bear, often including issues of power and control. In both scenarios, one firm will almost certainly be perceived as the stronger brand, and the senior party to the transaction.



Building a merger scorecard in practice

The detailed make-up of a merger scorecard will vary from firm to firm, but there are a number of core criteria one would expect to see. To be clear, the scorecard is not to be confused with any detailed due diligence process, which will occur much later in the negotiations. The scorecard is necessarily constructed on the basis of public information and trusted opinions; it cannot have the same level of certainty of detail as one would seek in a fuller disclosure. A merger scorecard checklist would typically include factors such as:

1. Culture and values
2. Legal practices
3. Market sectors
4. Client profile
5. Brand and reputation
6. Geographic footprint
7. Management capabilities
8. Financial performance
9. Structures and processes
10. Numbers and demographics
11. Infrastructure, IT and property
12. Risk and professional indemnity
14. Ownership and governance
15. Alliances and joint ventures

Information of this nature will often be gathered from a range of sources, with varying positions across the objectivity-subjectivity spectrum. Sources could include:

- personal knowledge from within your firm;
- your contact network, such as intermediaries, referrers and suppliers;
- the target firm's website and other promotional materials;
- media coverage at legal, sector, regional and national levels;
- industry awards;
- independent certification such as Lexcel, Investors in People;
- third-party databases, such as the Law Society's Find A Solicitor;
- directory rankings and commentary such as *Legal 500*, or *Chambers*;
- corporate deals databases like Mergermarket;
- LLP accounts;
- Knowledge management systems such as customer relationship management databases and contact reports;
- syndicated and bespoke research reports; and
- tender debriefs and client satisfaction feedback.

Taking all of these factors into account, it is possible to map the options open to you in terms of their positives and negatives, in a decision framework. The figure on page 11 shows what this might look like for the example given above.

Similar frameworks can be developed to review other sets of options in a structured way, ensuring that the strategy team takes a holistic view to maximise its decision-making effectiveness.

4 SHORTLIST THE POTENTIAL CANDIDATES

The most appropriate approach for this stage of the process will depend on the specific nature of the deal being sought. For example, is the desired merger a local market consolidatory move, part of a more expansive strategy to enter new geographies, or a step towards building a more diverse practice? This, plus your decision frameworks, will tell you what region or area to look for candidates in.

Methods for identifying potential merger candidates range from the solely quantitative (structured, objective research, using tools such as market databases, research reports, directory rankings and independent feedback, to surface and analyse options on a wholly objective basis), to the solely qualitative (much more subjective views expressed by partners or other professionals such as accountants, agents and banks). The first approach, while analytical, runs some risk of not picking up on cultural nuances which may be significant, but the second approach is based on personal relationships, so it may be incomplete and, because it is somewhat reliant on hearsay, market rumours or individual views, it may be skewed either positively or negatively.

External facilitators can prove useful in this process. They should be able to meld both objective analysis and their own deep knowledge of firms' cultures and personalities to identify the appropriate candidates. Inevitably, the firm may favour candidates which are already known and where cultural compatibility is seen to exist. This is both understandable and appropriate, as a line of least resistance; however, 'liking' must not supplant 'strategy' in the process. Having partners (or external facilitators) in the negotiation who are independent of any pre-existing personal relationship is a pragmatic way of minimising these risks.

The end result of this process will be a shortlist of candidates with a good level of fit on all the desired dimensions, as identified objectively in the weighted scorecard.

5 DO THE DOABLE DEAL (WITHIN REASON)

We have already discussed that the number of merger candidates which offer good 'fit' will be limited, with compromise and trade-offs likely to be necessary for both parties. In addition, a practical but nonetheless critical consideration at the moment is that the pool of potential merger partners is diminishing on an almost weekly basis; put simply, the market is not replete with attractive candidate firms. In such consolidating markets, those firms that are clear in their purpose, decisive, and quick to act are most likely to succeed. Inevitably, the success of the fleet-of-foot diminishes the pool of candidate firms further.

All this means that unearthing the doable deal is now the true goal. It may be much better in this market for firms to act on a merger fit that is 90% right and then manage the risks afterwards, than to seek the perfect partner, while potentially attractive opportunities are snapped up elsewhere. Moreover, the inability to identify the 'perfect partner' must not be allowed to be used by naysayers to prevent progress.

However, while compromise is likely to be pragmatically necessary, it is essential to maintain focus on the strategic goals identified at the start of the process. Otherwise, it is all too easy to be side-tracked by the unexpected opportunity or persuaded that a business fit or cultural alignment is stronger than it really is. The process identified above will help to ensure the firm retains this focus: it will provide an objective view of the quality of the fit, making it much easier for the negotiating team to balance the risks of any compromises and trade-offs.

6 KEEP IT LIVE

In this fast-paced environment, both your business and that of potential partners may change, either before or after you achieve the merger. The scorecard should therefore be viewed as a dynamic tool; the criteria and gaps should flex, as organic and inorganic developments change the shape of the business and move it towards its ultimate strategic goal. The strategic goal itself will also move, as competitive forces, client requirements and market conditions change the nature of our industry; an iterative, incremental and evolutionary approach is essential.