The benefits and pitfalls of buying / merging a solicitor practice

19th August 2021

1pm

Charnwood
for Solicitors

Intro to Charnwood Accountants

- Formed in 2004
- Act for around 40 solicitor businesses
- Chris Hutton

MISSION FOR THIS SESSION

To give practical and constructive advice to attendees who are considering buying a practice and to ensure you have the power to ask the right questions in early stage discussions

Main points for discussion

Structure and mechanism, including logistical issues to consider

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Valuation and financing

Other matters to consider

Acquisition / Merger, what is the difference?

Merger:

A combination of 2 of more companies to form a new entity.

Acquisition:

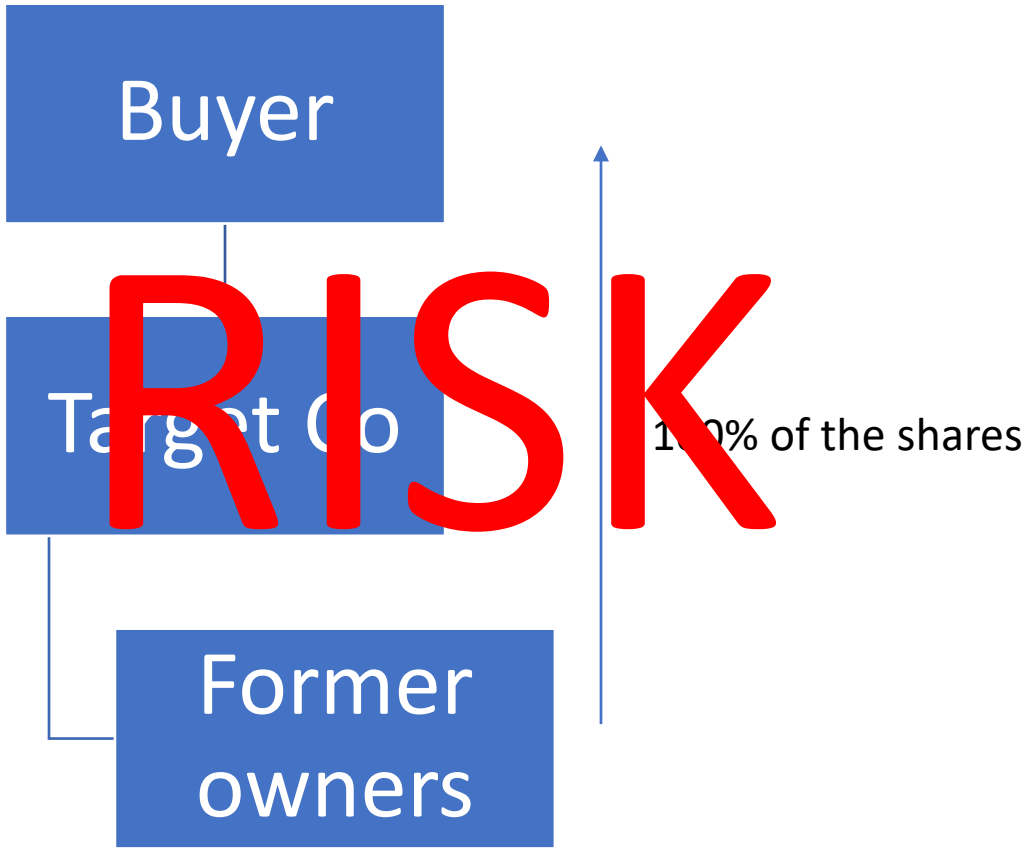
The purchase of another entity, either by acquiring more than 51% of the share capital or taking over the company assets.

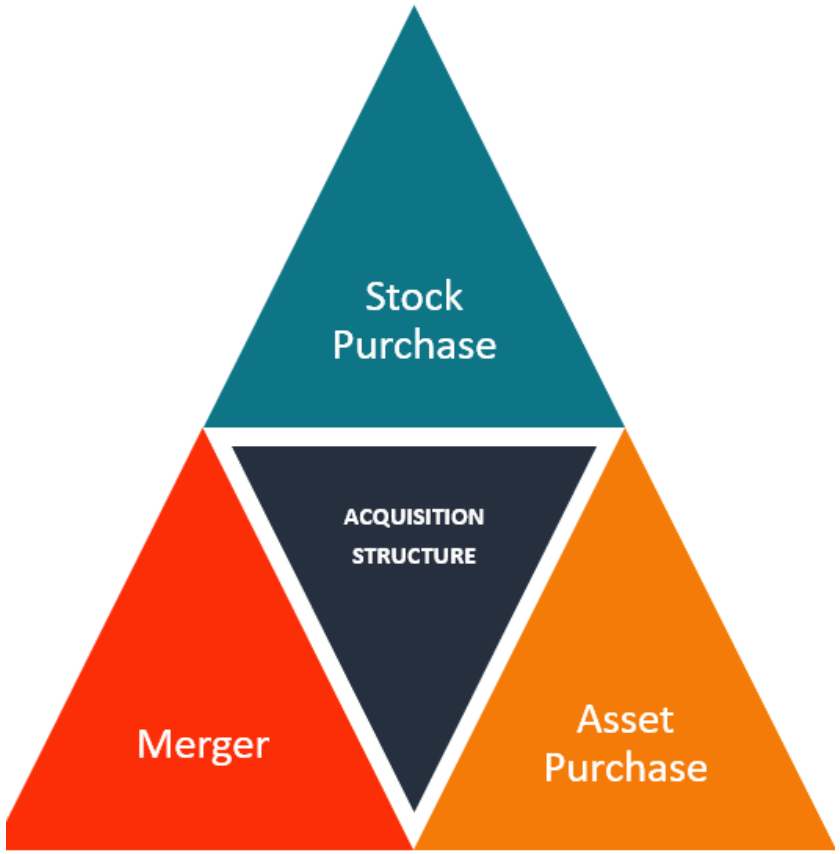
- Practically, there is very little difference in the world of solicitors.

- Usually involves one dominant party who remains as the trading vehicle and brings the other into it.

- For example A & B LLP merges with C LLP becoming A, B and C LLP. A & B is the dominant entity and acquires the assets of C. C takes an equity % in exchange for their assets.

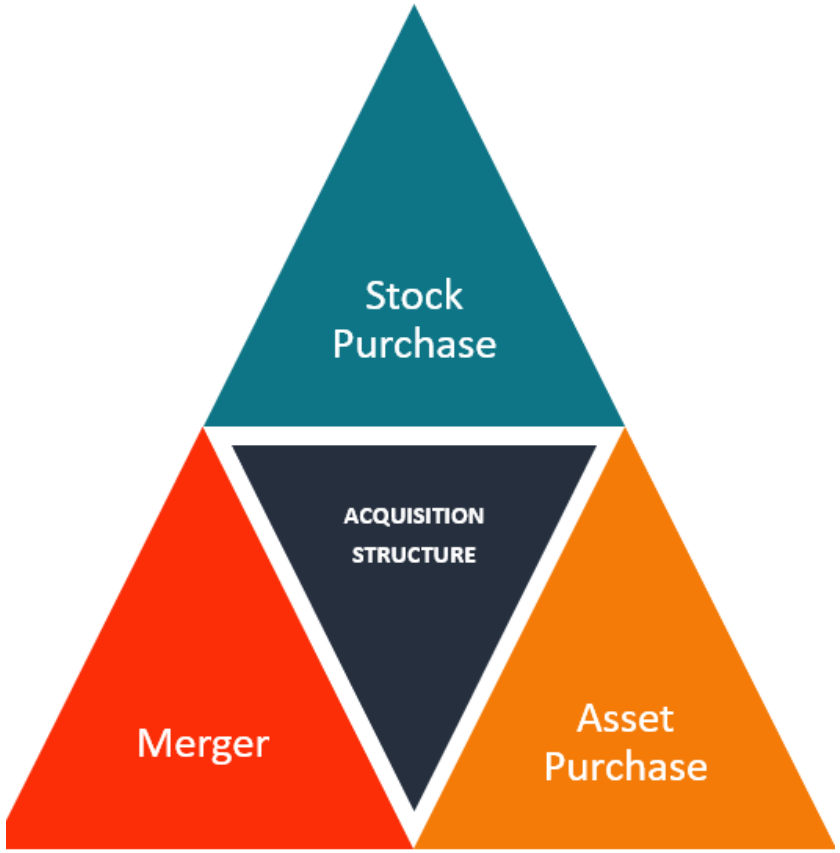
How to structure an acquisition – Share purchase





How to structure an acquisition – Asset purchase

Assets/Goodwill sold to the buyer



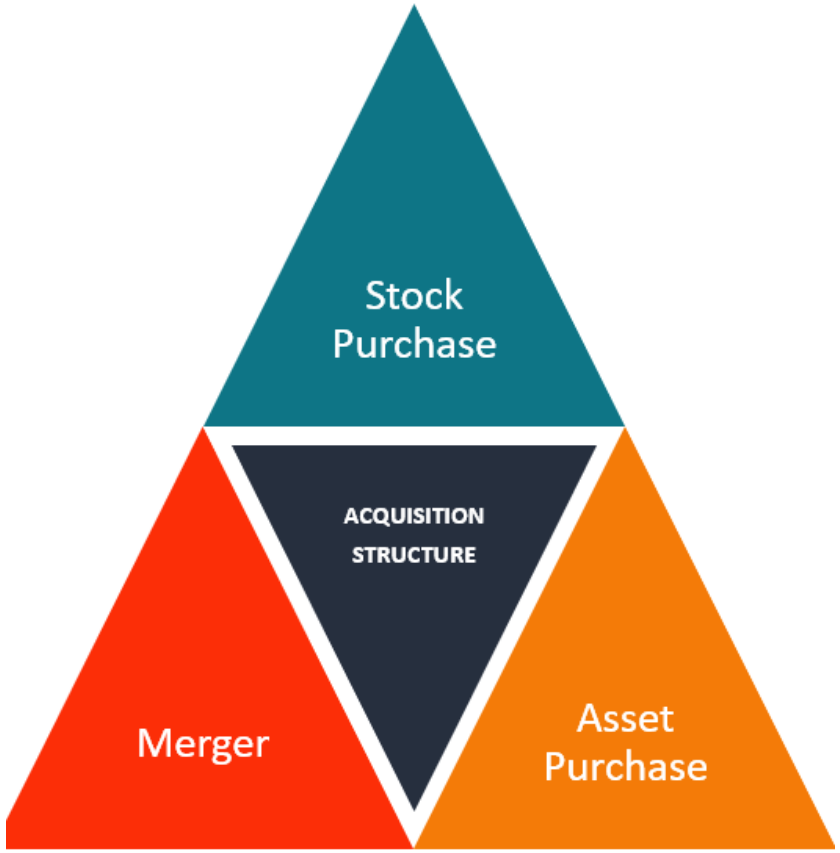
How to structure an acquisition – Management Buy In/Out

An MBI or MBO are very similar, An MBO is buying out all of the owners, an MBI is buying a proportion of equity.

Due to management involvement in the day to day running of the business a share purchase is a less risky option.

Would likely be undertaken via n acquisition through a new holding. Why:

- Sellers would get capital treatment on sale of shares.
- Buyers would not have to pay higher rate tax on extracting the funds to finance the purchase.

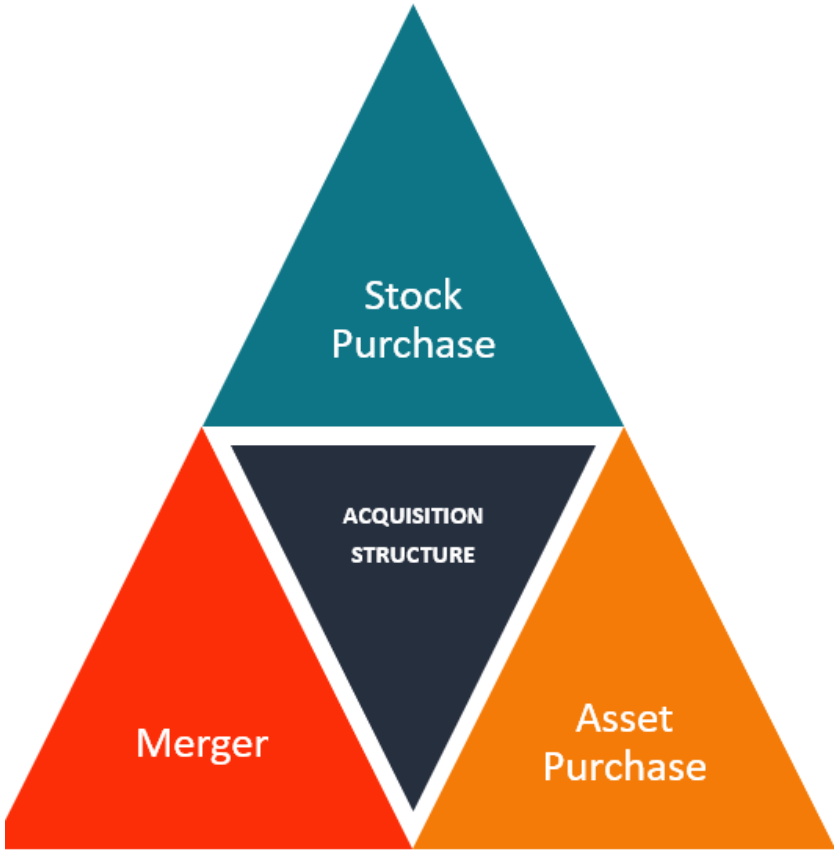


How to structure an acquisition – The tax position for buyers

- Corporation tax relief on Goodwill on acquisitions dis-appeared in December 2014. Since 2019 goodwill relief available at 6.5% on the following assets; Patents, registered designs, copyright, design rights and plant breeders rights. Therefore solicitors unlikely to qualify.
- Some relief may be available on tangible assets purchased as part of an asset purchase.
- No ongoing tax relief available on a share purchase.

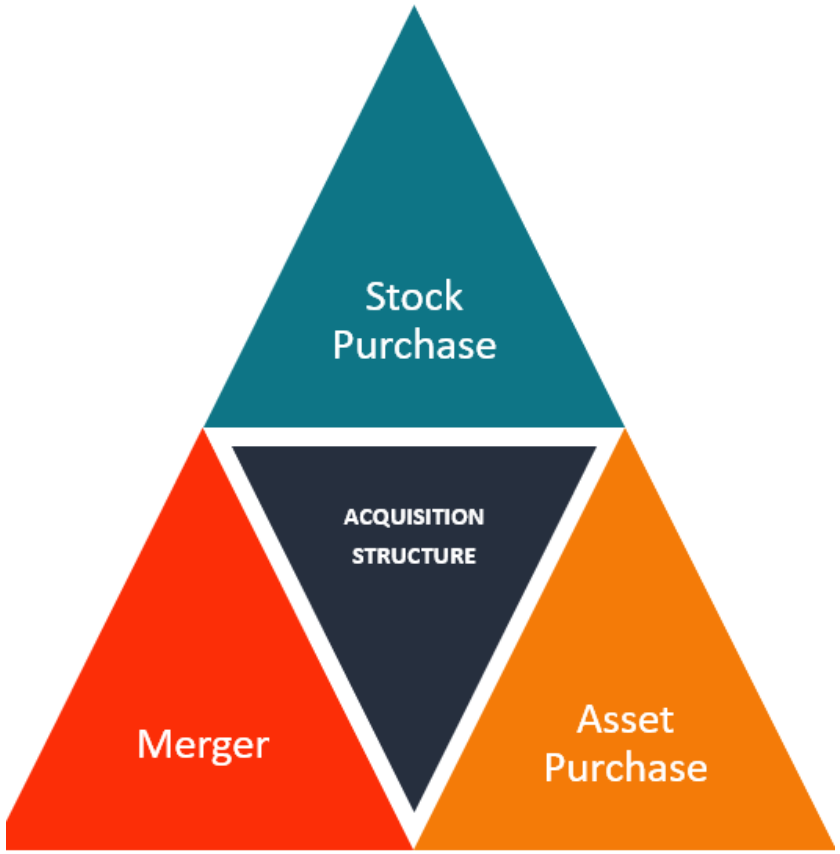
Thinking about the longer term:

- Asset purchase will form a base cost for a future asset sale.
- Share purchase base unlikely to have any bearing on future decisions given substantial shareholdings relief available.



How to structure an acquisition – Minimising risk

- Undertaking an asset purchase instead of a share purchase.
- Undertake a comprehensive due diligence exercise.
- Live a breath the target business for at least a month before signing.
- Understanding the client relationships and where enquiries come from?
- Appoint a good commercial solicitor to write up the SPA / Asset purchase agreement.
- Think about a handover period with the sellers.



Valuation and financing How much is my practise worth?

A business is worth what someone is willing to pay and what someone is willing to accept.

Historical attitude is that goodwill in law firms is all personal goodwill of the partners and therefore no 3rd party value. Attitudes have changed in recent years

How to value a solicitors practice

- It really depends on the circumstances!
  - What aspects of law does the practice undertake?
  - Recurring income sources?
    - Such as employment advice support contracts.
    - LAA contract awards etc
  - Personal goodwill in the business
  - Is it for 100% of the business, control or a minority stake?
  - Reputation.
  - Who generates the income, staff or partners?

How to value a solicitors practice – 3rd party

A practical example of a recent case:

- Multi discipline practice (No conveyancing).
- Ltd Co, 1 equity owner/director, 1 employed director.
- Turnover circa £1m per annum.
- Pre-tax profit circa £350k per annum.
- Business valued at £750,000 to £1m and sold within this range. Adjusted profit after partner replacement salary of £250,000 at a 3-4x multiple.
- Buyer also entitled to excess cash in the business at the deal date.
- Deal was paid partly up front and 75% over 3 years. Funding gradual retirement.

MBO / MBI

Similar principles likely to apply.

- Discount might be agreed due to loyalty and generation of profits over the years.
- Anti-embarrassment clauses might need to be included to protect the sellers. Becoming more common as values increase in law firms.
- Sellers will likely expect all of the current account/reserves to be paid out in addition to the consideration.

Financing an acquisition

Very few deals now complete with cash on completion, across all sectors not just solicitors (Vendor financed is a common phrase).

Lets say a deal is done at £800,000, plus net assets on completion of say £100,000:

- On Completion would be £200,000 of consideration plus the assets of £100,000.
- Then £200k per annum for 3 years.
- Deferred amounts funded from profits.
- Initial cash, some would come from the business, balance borrowed.
- Current attitudes of high street banks mean unlikely to finance a deal unless security available (eg property).
- 2nd tier lenders likely to be interested (eg Funding Circle, Aldemore, Oak North etc) Typical borrowing rate around 8% plus 4% front loaded fee.
- Ensure you draw up long term cashflows to ensure the model is affordable. We can help you with this.

Other matters to consider

Do you have the time to commit to an acquisition and integration?

- Speaking from experience it will destroy your chargeable time!
- Ensure you have the support of the other partners if you are leading this.
- If profit splits are linked to billable performance ensure this is discussed before progressing.

Associated costs:

- Along with time, you'll have costs of the following:
  - Due diligence
  - Legal fees
  - Financing costs
  - Possible insurance run off

What happens if things go wrong?

- You enter into an acquisition with deferred consideration and the performance isn't as expected, can you generate the funds to meet the commitment?

Insurance

- Ensure you understand who is at risk in relation to historic files.

Compliance

- You MUST ensure you deal with the SRA appropriately. We recommend DG Legal to all of our clients and they are ALWAYS exceptional!
- In respect of client money, you need to ensure client money is protected at all times and that clients are communicated with.

Summary – Benefits and drawbacks

Benefits / Opportunities	Drawbacks /Complications
Expand the business and income generating capability	Time
Economies of scale can be obtained	Business risk
Access to a new staff base	Financial risk
Expand service offering	Insurance – Ensure you understand any burden you are taken.
For MBO teams its an opportunity to uncap their earnings potential and take control	Tax legislation changes – CT rate increasing to 25% in 2023
Bring new energy into old fashioned businesses	Compliance - getting SRA authorisation and managing client money will be time consuming

Any questions?

The shameless part

- We’re looking to grow our solicitors department and would love to work with more solicitors.
- We think we’re very good at it but don’t take our word for it.

One off offer for attendees:

A free 2 hour meeting to discuss their business, it’s structure and any opportunies for acquisition or succession etc.

And finally……

- We also work with solicitors as their 3rd party tax specialist on work such as:
  - CGT reports in divorce and estate cases.
  - 30 day CGT reporting on conveyancing transactions.
  - Business valuations for disputes and as expert witness.
  - Retainer service for ongoing tax advice for your teams.
  - Assistance with tax planning for corporate transactions.
  - Assistance with tax planning in complex trust matters.

Thank you all for taking the time to listen today

Slides will be sent around

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Thank you for listening

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