Evaluation: ABS and investment in legal services 2011/12-2016/17 - Annexes

An analysis of investment in legal services since the introduction of ABS licensing

June 2017

Contents

Annex 1. ABS survey

A.1.1 This survey was conducted online between 8 December 2016 and 27 February 2017. We received 204 fully complete responses out of a total number of 846 ABS. That gives a margin of error of 5.98% at 95% confidence level. We can be 95% confident that the population of all ABS would pick an answer that lies between +/- 5.98% of the percentages reported in this survey.

A.1.2 The tests below demonstrate that the respondents can be seen as representative of the wider population on two key measures – type of Licensing Body and the year the ABS licence was granted. We do not have access to other data to assess representativeness in terms of type of work undertaken, and size of business.

Figure 1. Nominal data, frequency counts, Chi squared test: Breakdown by LB

	Observed	*Expected*	*Difference*	*Difference Sq.*	*Diff. Sq. / Exp Fr.*
CLC	17	0.07 (14.28)	2.72	7.40	0.52
ICAEW	29	0.2 (40.8)	-11.80	139.24	3.41
IPReg	10	0.04 (8.16)	1.84	3.39	0.41
SRA	148	0.69 (140.76)	7.24	52.42	0.37
n	204				

A.1.3 The Chi^2 value is 4.718. The P-Value is 0.194. The result is not significant at $p=\leq 0.05$.

Figure 2. Nominal data, frequency counts, Chi squared test: Breakdown by Year licence granted

	Observed	*Expected*	*Difference*	*Difference Sq.*	*Diff. Sq. / Exp Fr.*
2011 & 2012	26	0.09 (17.66)	8.34	69.56	3.94
2013	36	0.23 (45.08)	-9.08	82.45	1.83
2014	30	0.18 (35.28)	-5.28	27.88	0.79
2015	59	0.31 (60.76)	-1.76	3.10	0.05
2016	45	0.19 (37.24)	7.76	60.22	1.62
n	204				

A.1.4 The Chi^2 value is 8.226. The P-Value is 0.084. The result is not significant at $p=\leq 0.05$.

A.1.5 A full copy of the survey and anonymous responses can be found on the LSB website at https://research.legalservicesboard.org.uk/news/data-sources/

Annex 2. Note of project workshop

Roundtable to discuss possible barriers to investment in the legal sector

Legal Services Board, 1st December 2016

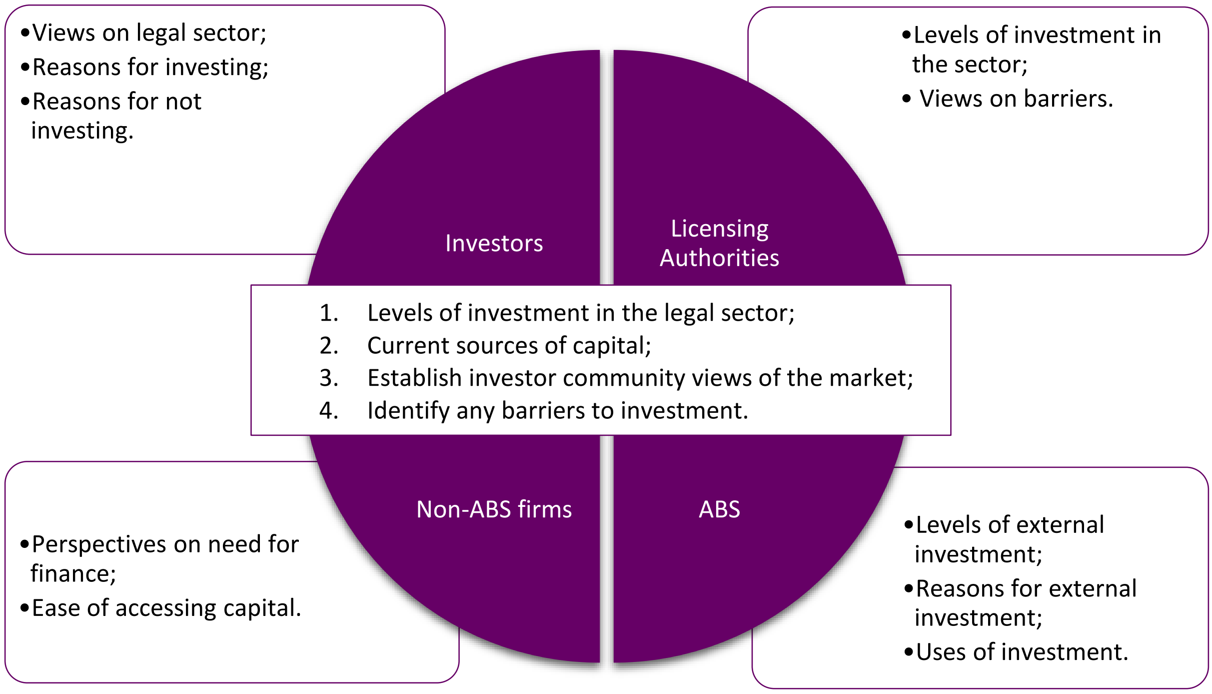
Attendees

- Steve Arundale – Head of Commercial Professional Services, RBS
- John Llewellyn-Lloyd – Arden and Partners
- Philip Jones – City UK
- Steve Billot – Symphony Legal
- Mari Sako – Said Business School, Oxford University
- Sundeep Aulakh – Business School, Leeds University
- Ian Kirkpatrick – Business School, Warwick University
- George Hawkins – SRA
- Simon Thomson – CLC
- Peter James – ICAEW
- Victoria Swan – IPReg
- Christy Farrer – Law Society
- Caroline Wallace – LSB
- Steve Brooker – LSB
- Robert Cross – LSB

The proposed scope of the project

As part of the LSB's work programme looking at *breaking down the regulatory barriers to competition innovation and growth* the LSB is looking at investment in the legal sectors. Permitting non lawyer ownership of regulated law firms was a key part of the Legal Services Act 2007. It has now been over five years since the first Alternative Business Structure licence was granted.

The group were shown the proposed approach to the research project as set out below:



Given the lack of information in this area, highlighted in our 2016 market evaluation, our proposed approach is to look at this issue from four perspectives, to seek to address the four objectives of the project. The main focus is regulatory barriers to investment in the sector.

The LSB was challenged on whether the LSB was looking at investment as an end in itself. In fact, from the LSB's perspective, this research is linked to the wider objective of breaking down barriers to competition, innovation and growth. It was agreed that competition is likely to deliver a range of benefits including a greater diversity of services, better value for money, and not just lower cost.

The group asked why the scope of the project didn't include unregulated providers. The reasoning for this was both practical and regulatory. Those that are unregulated by the Legal Services Act (LSA) are more difficult to engage with and as they are not subject to LSA regulation are unlikely to face legal sector specific regulatory barriers to investment.

The group discussed the need for greater segmentation in understanding regulated providers, for example based on scale, activity, outlook and geographic region – all of which will impact on the potential level of investor interest in a business.

Investors are agnostic on regulation, they are more interested in the fundamentals of whether the firm can grow. Accessing capital is less of an issue than seeking out opportunities to innovate. In converting to ABS, there tends to be no driving demand from firms for investment, but some do wish to reward IT and other non-legal staff with shares of ownership. However, there are a number of firms seeking investment, especially those trying to expand new business models.

Law firms are either comfortable where they are or are in dire straits. The prevailing culture (especially for medium-sized and small firms) seems to an extent to be to wait and see what others do before acting and avoid risking failure.

It was felt investor interest will mainly be in MDPs as combining legal services with other professional services is seen has having real potential for growth. Accountancy services will be the primary focus of this interest, but others are estate agents, architects etc.

Consumer services are very different from business services and are potentially a bigger growth opportunity, given the identified levels of unmet need and the level of risk involved.

The project needs to be clear on the authorised and licensed distinctions. For ICAEW, in some entities all principals are authorised people (effectively an MDP) but proportion of external ownership will vary.

It was recognised that only the minority of ABS firms will have any form of external investment.

In terms of what drove applications for conversion to a licensed body, for IPReg it was pre-existing regulatory requirements for MDPs to convert arising from the LSA 2007.

In terms of banking, most law firms don't have trouble accessing capital so can fund internal investment that way if needed. The possible barrier is identifying what areas to invest in.

It was suggested that most ABS conversions are about the firm having the ability to change in the future, rather than making changes now. Most partners are likely to be concerned about any loss of control – there is a big change in having a corporate master from being in a partnership. What a business wants is working capital as partners don't want to consider any reduction in reward i.e. no reduction in profit per equity partner (PEP). External investment is not seen as a reward for partners, but it could be given the potential for increased financial rewards.

Additionally it was felt that most firms with under £100m turnover have a lack of understanding of the value of their firm. This has been an underlying cause of some recent high-profile business failures. They don’t necessarily understand how external partners would value a firm, and PEP is not a measure of such value. Regulators could do more to ensure that the profession understands how to value their businesses. Firms don’t monitor the impact of their actions (e.g. PEP takings) on the firm’s value. Taking 100% PEP is in effect taking out 100% of the value of the firm every year. The poor state of many small firms’ finances could trigger a period of market consolidation.

Comparisons were drawn between historical consolidation in the accountancy sector and potential future consolidation in the legal sector. In accountancy there used to be the big eight whereas now there are the big four. Consolidation took 20-30 years in the accountancy sector. We may be at the beginning of the mid-market crunch in the legal sector.

Investment can come in different ways for law firms. The group discussed the example of lateral hires bringing with them expertise and new clients. Headhunting firms might have an insight into whether this is happening more than in the past.

Those firms that do separate management from ownership will allow longer term strategic thinking, and look at future value. The group agreed that generally speaking lawyers don’t necessarily have the skills to be good business managers. Existing partners have a level of ‘skin in the game’ and take liability professionally if the business is held to account for regulatory failures. Investors are likely to be able to get their money back but individual professional may never be able to work in the industry again. This explains the temptation of partners to continue to want to be involved in managing the business. Governance structures must allow management to manage and board members (or equivalent) to look after the value of the firm. The alignment of interests only really works with shares.

It was recognised that the actual number of new ABS firms is very small – LSB analysis suggests that around 30% of ABS licences granted by the SRA were to brand new firms. This was further evidence of the irrelevance of statistics on the numbers of ABS. However a number of ABS firms will be in house lawyers converting status to deliver services to the public and other business.

The discussion recognised that the partnership model works in terms of instilling ‘business-like’ thinking only if the number of partners is large. However only a handful of law firms have very large partnerships. It was noted that a big accountancy firm has more lawyers than the largest legal firm. It was felt that size is needed to deliver strategic change.

Investment might be driven by the need to provide technology – for example developing an app to provide new services, which will require investment. Another example would be the development of artificial intelligence. There are grey lines between legal tech companies and law firms – legal tech companies can be unregulated and deliver a wider range of legal services without being touched by the reserved activities. They may be far more attractive for investors than law firms.

There is also an international dimension to investment, so the project should seek to understand where the investor is, and where the ABS and consumers are. A related issue discussed was the lack of reciprocity in some jurisdictions around non-lawyer ownership. For firms based in E&W ABS won’t work for developing international business as non-lawyer management, ownership and investment aren’t allowed in other jurisdictions. Historical cross-border service delivery issues in accountancy were overcome (i) because multi-national clients demanded cross-border services and (ii) through the work of the International Federation of Accountants (IFAC) which provided international direction and equivalence for example through EU law.

Information on SRA regulated ABS

Dr. Sundeep Aulakh and Professor Ian Kirkpatrick presented an overview of their work looking at ABS and investor experiences. Key findings included:

- There were a range of factors causing ABS to search for external investment including response to changes in adjacent sectors (such as insurance) and within the legal sector. More proactive reasons include the exploitation of new market opportunities to accelerate growth, and organisations with charismatic and visionary leadership.
- Investors were mainly driven by changes to their home sector or an impression that the legal sector was a 'sleepy' market that was inefficient and therefore attractive for outside investment that can induce growth and deliver cost savings.
- Private Equity investors found the partnership model a barrier – specifically a lack of partner consensus, a reluctance to accept post-investment support, lack of 'Corporate' practice, and structural conflict within the partnership.

The research was ESRC funded and match funded by the two universities. It has a professional services focus. The research team had faced a challenge in getting access to investors.

Only one investor the researchers spoke to had been approached for a second round of funding, but that hadn't worked out. Investors reported that having an exit route was key. One of the research participants had exited, and one was planning to do so through the sale of the firm to another fund. Private equity investors will be looking for 2.5-3 times return on their investment over 3-5 years.

The group felt that the largest eroders of value identified were bad merger deals, and regulatory changes driven by government legislation, affecting firms' debt and capital structure. Investors dislike legislative uncertainty, such as that seen in the personal injury sector where there has been limited investment in the past few years. Court fees changes have impacted on the employment sector.

For the research project the key thing to capture is how diversified law firms are – if not diversified they are more at risk. It was also noted that the joint SRA-LSB innovation research shows that legislative change can be both a driver and barrier to innovation.

Information on CLC regulated ABS

Simon Thomson presented the key findings from the recent annual regulatory return of CLC regulated entities, Key findings included:

- Recognised bodies and alternative business structures (ABS) were of a similar age.
- ABS were less optimistic about their ability to raise funds.
- ABS were less concerned about maintaining control of their businesses.
- More than half of ABSs made substantial investments in 2015, compared to less than a quarter of recognised bodies (52% compared to 23%).
- The top three areas of investment were hiring more staff, IT for practice management; and consumer-facing IT systems.
- ABS were more likely to make investments in four of the six areas.

- The main source of funds for both recognised bodies and ABSs was business profits or cash reserves.
- The second most popular funding option for each entity-type diverges:
    - Traditional practices were more likely to use banks.
    - ABSs received capital injections from existing owners.

It was suggested by one attendee that the top four conveyancing firms, who have been gaining market share over the past few years, are all backed by private equity, though this could not be verified.

Theories for discussion

The LSB has been having discussions with a wide range of stakeholders as part of the initial work on the project. Based on these discussions we shared a set of statements about why the level of investment is where it currently is in the sector. These were:

1. Law firms don't need external investment as they have enough cash reserves;
2. Law firms don't need external investment as they have easy access to borrowing;
3. Regulations are getting in the way of investment in the legal sector;
4. Investors aren't interested because law firms don't know how to present financial information;
5. Investors aren't interested in the legal sector because it's too small in total value and businesses are too small;
6. Investors aren't aware of investment opportunities in the legal sector.

The group suggested that the first two should be rephrased because law firms don't see external investment as necessary, or as a way of bringing about desirable change. Possibly law firms don't face enough competition to need to grow their businesses in ways that require more capital.

Cultural change is likely to be a big blocker and should be added to the list of theories.

There is significant literature on status and status effects hierarchies (see further below). These same issues will be playing out in the legal profession. Investment will be associated with negative stigma – generated in part by press coverage and high profile negative experiences. Investment is seen as unethical – as the rules when many solicitors qualified would have banned such practices. External investment is not considered to be consistent with the 'brand' of solicitor in some quarters. It would be sensible to look at the age demographics of equity partners. Millennials will probably have a different outlook.

Status hierarchies suggest that if the elite embrace change, then others will follow. However given the financial viability of the larger law firms, and the cross jurisdictional issues around non lawyer ownership, there was little driver for external investment in the elite law firms. Change on the margins won't address this. It was suggested that the industry as a whole should look at this issue.

There was a discussion about the wider regulatory structure. Regulatory issues relate to how the sector deals with changes – change is disruptive. Generally speaking regulators won't allow change if the risk to the client is perceived to be too high. It was recognised that SRA are actively trying to stand out of the way of innovation. It was felt that where regulators try to address the micro behaviour of solicitors, they should instead should stand back.

The fourth and fifth theories were felt to be more an issue with firm governance structures. The issue is more likely to be that they don't understand governance. It is widely recognised that a wider perspective on boards is beneficial in other industries but it is not a cultural norm in legal services.

The potential for computerisation and disruption by new technology should also be considered.

Annex 3. Interviews with investors and lenders

Investor 1.

Interview date 9 February 2017

What first attracted you to this sector?

For two reasons mainly.

Firstly because we were asked by a lead investor. We are a co investor in a current legal business. The lead investor had researched the legal sector and built a relationship with the law firms. They were looking for a co investor and approached us. We have a good partnership with them and with the management team at the business.

Secondly it was about opportunity. The Act opened up the possibility for disruptive change in the legal sector. Our company had seen the effect of opening up a sector to competition in other industries, and the commercial opportunities presented by this type of reform.

While we have a range of international investments, and invest in broad range of sectors. The legal business investment is not an outlier.

Broadly speaking, why was this a good opportunity for your business?

At a high level lawyers don’t tend to think in the same commercial way as other businesses. Lawyers have admirable professionalism, and standards have to be maintained, but they are not business minded. It’s quite sleepy as an industry.

The business we invested in was not sleepy. They were already thinking more commercially and I don’t think our investment changed them massively. It probably helped focus their minds more, but they were already thinking commercially.

The impacts of investment are more subtle than just buying a legal business.

In a negative way the constant legislative and regulatory change has had a big impact. There has hardly been a 6 month period without some sort of change. The insurance lobby clearly have a well organised lobbying voice, whereas the RTA/PI sector is weaker. The insurance groups narrative of ‘cowboys’ in this sector has gained traction. We expected some of this when we invested in the legal business but the level of instability caused by the constant changes has been far greater than anticipated. This obviously impacts of our ability to sell on our investment and exit.

The medical portal implementation is an example of very poor handling of changes. There was no real thought about what they were actually trying to achieve. For example they were slow to crack down on people using shell companies to increase their profile, and when this wasn’t penalised the incentive was for more firms to do the same. The whole process was handled very badly which impacts on the level of uncertainty all businesses face. We would much rather have properly though through changes.

How does your experience of investing in this sector compare to others – were there any positives?

The quality of people in the management team has been a positive. We are yet to see the positive benefits of investing because of all legislative and regulatory changes. We would think twice about investing in another legal business because of legislative reforms.

What sort of things was your organisations investment capital used for?

First as a way of the management team taking cash out, we bought an ownership stake. The business model of the law firm we invested in is very capital intensive. As they grow the business has to fund claims and medical reports etc., and needs more capital. Cash flow is slow in litigation cases, and contracts can have forward payment clauses. The investment has also been used to build up the brand and increase marketing.

Did you have any dealings with legal services regulators (e.g. SRA, CLC)?

Yes we did, around the approval process.

This was during 2012 and 2013. It took a very long time for approval and the process was unlike anything I've ever been through in any other sector.

The ability of the SRA was so uncommercial. They didn't seem willing to advise us on how to comply but wanted us to submit a proposal assess it and if it was wrong start the application process all over again. It felt like a just a box ticking exercise, with no reference to reality.

They even wanted to get our board representative to a criminal records check to provide details of his time aboard over thirty years before to prove he was a fit and proper person. There seemed to be a real risk of failure, of something going wrong after a firm had been authorised. There was a lack of proportionality but as I understand it the SRA had no scope to vary this.

The very real issue for us was the time it took – time has a big impact on documents relating to the deal. You do your due diligence and agree terms, and if it takes 9 months to get approval things could have changed so you need to add lots of complexity to the deal documents to account for this.

It was so difficult to get in to the market that it is effectively a barrier to entry, which having gone through the process is something that is good when you're on the inside. Making the process more commercially minded would be sensible but having been though it's now not in our interest that it changes.

Were there any regulatory hurdles or deterrents that made you think twice about investing that stand out?

Just the process and the regulatory changes I've already described.

What stops you from investing more in the legal sector?

If we saw a business that was good enough then we would consider it, but there would certainly be a sharp intake of breath in anyone suggested it, because of the changes to regulation and the application process.

What about other parts of the legal sector, such as conveyancing and probate?

There are opportunities there because of the lack of commerciality – we have seen this in other areas where they don't understand the cost of customer acquisition. But we would still think about it because of the experience so far.

Have you been approached by many law firms to talk about investment opportunities?

No we have not been approach directly. However we have been approached via the existing business, and have looked at other business opportunities.

What is your impression of the level of financial management with law firms? Do you think law firms are good with corporate management?

No they are not, which is part of the opportunity for third party capital. There are exceptions to this. Via our current investment we have been approached by a range of firms some with a strong grasp of their business, but some of the smaller ones really don't understand.

Given the aims of this project is there anything you expected me to ask you about that I haven't covered?

No, none.

Annex 3 – Investors interviews

Investment research – Investors interviews

Investment advisor 1.

Interview date 13 February 2017

What attracts investors to the legal sector?

We have advised private equity groups about investing in law firms, and investing in firms that provide services to law firms such as technology or outsourcing.

There are two or three reasons that attract investors. Firstly law is a relatively stable business – most firms' year on year have the same or higher revenue. They see it as an unconsolidated market meaning there is the potential for growth within the market and room to consolidate even if the legal market is not growing overall. From an investor's perspective, law firms also have impressive profit margins but they don't believe firms run themselves very well.

Is there anything that makes the legal sector a unique opportunity for investors?

It is sector that is not necessarily correlated to other parts of the economy. There is less fluctuation. A wider down turn doesn't mean that law firm's work will fall. It's not like an estate agency business. Firms in the legal sector have a portfolio of business in different areas so they are not as tied to the whims of the wider economy. Also a contraction in the economy can generate more work for lawyers.

What's happened with the investor you have discussed with? Have they invested in the sector?

The majority of investors have walked away. They haven't found targets that can use the money wisely. Private Equity groups are looking for double digit returns and exit after five years. There also has to be a return for the partners, and there just aren't the opportunities.

The challenge is that many firms are people businesses. Investments have taken place in the more commoditised businesses - for example Parabis and Slater & Gordon. But these models have been side swiped by hubris, changes of rules, and subsequent changes to the economic model. These two high profile firms have had troubles – Parabis went bust with a big loss for investors and Slater & Gordons share price has fallen significantly. These are two high profile negative examples that deter others from investing.

The positive example is Gateley. It's a mid-tier law firm that has grown its share price significantly and is a solid performer. I am surprised no other law firms have floated as this has big potential, but the personal injury reforms have had a big impact on investment in that sector.

How does investing in this sector compare to others?

As a people business it is different from other sectors. The challenge is to keep people motivated and committed to the business. In the traditional model they have a profit share at the end of the year so they remain motivated. Shares, share options, and a lower 'day job' income has a very different dynamic for people. Investment means keeping people committed and enabling the share price to continue to grow. There is also a reliance on keeping and motivating the partners and keeping them involved with the clients. This is why investors initially focused on the commoditised businesses where this is seen as less of an issue.

What's also holding back private equity is the possibility of clear exit from the investment. There aren't many consolidators in the legal industry who would buy out the investors. There just aren't many classic trade buyers, and most law firms are reluctant to give a realistic exit price. As a people business it's not like other businesses such as retail, this is similar issue for listed accountancy and estate agency businesses.

And what do the investors you talk to think of the regulators? The SRA, CLC ICAEW?

I don't think they are massively phased by the regulations. Both the SRA and LSB have given a very clear welcome mat. Historical log jams have been cleared now. Investors recognise regulated industries so are used to regulation, and aware of what hoops there are and what the issues might be. Investors might ultimately prefer no regulation but regulation is needed for a reason. Historical issues are historical and I have no impression this is a serious block. Reforms to the SRA handbook will only help this as well.

Investors when they are dealing with incumbents have found very few willing to sell – only those firms in deep trouble and they are too risky. Start-ups need substantial amounts to build up scale, and private equity firms don't want to invest that much. Examples of Direct Line, Spec Savers and Vision Express all needed lots of investment over a sustained period to build up brands such as the little red telephone. Quality Solicitors tried a franchise model but didn't have the back office systems and level of investment to follow this through. Co-Op had the brand but other issues in the business had a big impact – diverting management away from developing legal services.

The amounts invested have been relatively small. In the scheme of things £5m is not enough to develop a recognisable brand in the retail space, it needs far more than that. The amounts invested so far are far less than is needed. Other high profile brands – for example the AA, Tesco – have other things to concentrate on rather than legal services.

So is it more the case that investors are looking for opportunities or firms are looking for investors but unsuccessfully?

Its more investors struggling. Decent firms already have access to cheap debt. Firms also have easy access to long term debt if they really need it. That means it's only a few that need the investment finance in the first place. I did think that as the baby boomer generation reached retirement we would have seen more private equity involvement as a way of buying out partners but this hasn't happened and it's unclear as to why. I have never heard from a law firm with a good business presenting a need for finance that's unmet.

What makes Gateleys different is that have a fairly dynamic leadership, and have had sustained mechanisms for growth over the past twenty years or so. They have taken steps to lock partners in – have a look at their AIM offering memorandum – so that they keep people and that's very important. They have been very careful with their acquisitions. They have positioned themselves as a good safe stock, distributing around 70% of their profits and have met or exceeded market expectations over the past two years.

There is one other organisation that's been consolidating and looking to do an AIM float but that hasn't happened yet.

I expect if there were 3 or 4 you would then get more growth as they get more attention from analysts. Historically accountants did something similar, but most of these failed e.g. Tenon. Smith and Williamson, the accountants, do have an outside investor and do have an internal market for shares. Murgitroyd which is a patent and trademark business is also listed.

The only services sector where there has been a range of financial models is property agency, e.g. Savills, CBRE Knight Frank etc. where there are partnerships and listed companies operating in the same sector. Don't forget that listing is very rare in professional service businesses in any sector.

What is the overall impression of the level of financial management with law firms? Are firms good at a corporate management?

This is a contributing factor to lower levels of investment. Law is a relatively profitable business and so it doesn't tend to have the business discipline that it might otherwise need. Generally speaking, WIP and debtor control are sub optimal, pricing decisions are poorly made, and understanding the profitability of individual pieces of work is very poor. Medium and smaller firms just don't have the calibre of CFO. Decision making on expenditure is not as robust in law as it is in other industries. If partners are still making six figure incomes there is no limited pressure to do this.

To be clear financial controls are there, firms are compliant but cost control is not as tight or efficient as it could be. This will be true in some larger firms as well – for example the recent collapse of KWM Europe.

Law is quite lucky as it changes at an evolutionary not a revolutionary rate – there is no IPhone coming along to destroy Nokia comparison. All of it means that the rigour that could and should be applied to financial decision making just isn't going to happen – for example opening an office when where and how, it won't be based on decisions about how much it will cost, what's the likely cash flow, and what is the return on investment (ROI).

Given the aims of this project is there anything you expected me to ask you about that I haven't covered?

You need to be realistic. Investors are wary of people businesses. Firms are resistant to tighter financial and business controls, and to losing 'control' of their destiny.

Reform should be seen as a process. We haven't yet seen investors come in with a big war chest. The market sees something as threat or an opportunity. Once investment is seen as a successful option they will get with the programme. As of yet there haven't been lots of examples of success, had other been successful this would have been different.

Regulation – not by regulators but by central government - has had a big impact, Changes to referral fees, whiplash reforms, and fixed cost have all impacted on the potential for investment. Because of current and future government reform the personal injury sector is in a state of flux. I recognise that in an environment where the cost of legal advice is more than the damages then you need to do something, but it has a negative impact on investment opportunities because of the instability.

There are many trying to promote the opportunities for investment in the legal sector – there is not lack of evangelists. However we have a very small number of firms who have actually taken external investment. This is because the current models don't feel the need, and there is no start up that has taken the market by storm.

Investment research – Investors interviews

Lender 1.

Interview date 28 February 2017

Could you tell me more about your business?

We are a corporate bank who lend to a range of business of all sizes. We are organised by industry sectors so that we can have an understanding of the different sectors and the businesses we lend to. We lend a range of professional services, but legal services are the dominant group.

We have significant market share and our relationship directors have a strong working relationship with law firms, and good links with local business community.

The legal sector hasn't changed for a long time, but is now changing more. There is huge amounts of noise about the impact of tech, but it's not really clear what is actually changing.

AI impacts so far have mainly focused on document reviews. In a sense it is removing lots of work that would have been done by junior staff which brings challenges for the next generation of partners. You still need law firm partners to do what they do. The parallel for us is accountants – software is taking over the role of junior accountants.

The 2007 legislation allowing non lawyers to have a significant role in the business tends to improve the success of the business. Having a financial director that has to go out of the room for some of the discussion at board level is not likely to drive success. The professionalization of management within law firms was happening anyway but the perhaps would happens as fast without the legislation.

Law is not an easy environment, clients want more for less, some organisations are changing their panels of law firms to reflect a changing global pattern of business. This is more at the higher end of the market. Revenue at law firms is not increasing like it has been I the past but costs are increasing either through inflation or salaries. Salaries are growing as a consequence of near shoring – Magic Circle / Silver Circle firms opening offices outside of London potentially creates wage inflation in the local market as they typically pay higher salaries whilst still paying less than they did in London. We do find that London firms are cuter on costs but that's because they are under more pressure to keep reviewing their costs. As a market is the legal sector one that private equity would actually want to invest in?

We tend to lend debt capital not capital for mergers of firms, but capital for fit outs, new premises, IT that sort of thing. We will lend to support mergers, but we're not typically asked to do so. We do provide partner capital loans for new partners of those firms we have a relationship with already. We also provide a c 3-5 year committed line of funding for larger firms. The view of generation Y not being as interested in partnership isn't supported by research I have seen – that shows that it's always been only a certain proportion of lawyers that want to be partners anyway. It's not a new thing. People want to build a range of skills at one firm and move onto the next one.

What makes the legal sector attractive for a lender?

It is a reasonably stable, small 'c' conservative, low risk, and the majority of firms are well capitalised with a good history. The LLP model does have its challenges, the tax incentive is to draw out the cash at the end of the year which means that there is little left for investment.

I was surprised at a recent discussion where a number of firms, LLPs, were more likely to say they were keeping back more to invest in the future.

How is it different to other sectors?

Architects don't borrow, and accountants borrow in a different way. Historically solicitors had all the client account money which made them very attractive for lenders and so overdrafts were every easy to come by. I think the client account used to be call the 7th partner because of the potential for income. This has changed though. The banks now have to put capital against the money. Basle III regulations are coming into effect – fully in 2019 – and mean that the client account capital is treated as instant access. Banks are now reducing interest rates on this as a result. Law firms will complain about deposits because of the low interest rates on offer but rates are likely to be lower in future if there are no more changes.

Do you have any dealings with legal services regulators (e.g. SRA, CLC)?

We have had some level of interaction. The changes some years back meant SRA have a different approach more of here are the rules now go away and apply them. There is a similar approach in banking. There aren't many other sectors where we actively engage with regulators.

What about reform to regulation and lending?

Clearly we conform to all lending regulations. We do possibly look at coming regulatory reforms. We haven't lent to personal injury firms but that's because of the very long capital repayment periods. Personal injury is potentially high risk and high reward, and any business would want cash flow from other sectors. I think most firms are deprioritising work in personal injury. The defence side is different. Firms defending insurance companies are more likely to benefit from interim payments, which benefits their cash flow. When lending we try to look at everything.

You mentioned earlier the likely impacts of technology?

Yes, the legal sector will get disrupted at some stage it's only a matter of time. Estate agency provides an example, why would you wait until Thursday to list your property when you can list it straight away on Rightmove? Law does stand apart but it will still get disrupted. Conveyancing is a process. You do get bunkers with lots of paralegals working through cases, and the high street responded with fixed fees. We can expect these things to grow as consumers become more aware. That's unlikely in family because of the need for court process and the different types of family breakups. Commercial operates want to pay for the best advice, but it's also a process in many ways. One example is derivative documents. This use to be a labour intensive process but now it's outsourced. One example is Axiom a new provider that is used for legal process outsourcing and is not there to replace larger law firms.

Do you think there is much demand for private equity capital among law firms?

Tax changes will have made the ABS structure more attractive. A whole bunch of firms in the sector that aren't small, have say two offices, three to four partners, haven't thought about succession in any way, and they don't have anyone to buy them out. The ABS structure for investors could work, through buying up firms to grow scale, but what would be the benefit of economies of scale in law? The Business Growth Fund has one firm that's doing this, Gateleys have had an IPO. Sceptics don't really understand what happened to the capital raised – how much of it was used for buy outs. Other examples where the firms keep the exiting partner on as a consultant but don't get a pay day on retirement. I would say that a number of partners retiring don't want to close their business partly because of reputation but also because of runoff cover and file retention.

Private equity companies aren't daft – if it was a great opportunity they would be there. The examples to date aren't good. Banks understand the corporate structure of firms and partners role in extracting capital. Some partners want a pay day for ABS conversion and to keep the same level of drawings which just isn't realistic. It's part of the partners as employee and owner conflict.

What is your impression of the level of financial management with law firms?

If I was private equity, corporate management wouldn't be a problem. I would change the board. The main concern would be how does a private equity company drive an exit? In a sector where there were large trade buyers it wouldn't be a problem, they could take a firm grow it and sell it.

In the sector the impact of non-traditional providers on the legal market, for example PWC. This is an uncertainty that a private equity company won't like. PWC is a very easy cross sell in any commercial acquisition.

It's too easy to say law firms aren't as well run as other professional services firm. There is a range of law firms and a range of levels of management. They could be better at collecting cash and billing for time, for example the partner who discounts a price even though it's already been recorded as WIP in the businesses accounts.

Given the aims of this project is there anything you expected me to ask you about that I haven't covered?

I think there is demand for investment, just perhaps not from traditional private equity investors. I definitely think there is a role for longer term (patient) capital in the sector. Most firms of any size will have good access to borrowing – they won't have a liquidity problem.

The sector will change if profitability declines, so individuals might not want to be partner and go and work for an ABS. It's worth adding that mergers won't always work it takes more than just joining two firms together to successfully grow. Many mergers do work, particularly where both firms have invested time understanding the culture of their merger partner – my point is more that success isn't guaranteed