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Large Law Firm Mergers: What's the Verdict?

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In 2003 Altman Weil did a study of 17 selected large law firm mergers in which at least one firm in each merger was over 100 lawyers. Among our conclusions:

- the vast majority were profitable from year one;
- merged firms increased their profitability greater than increases in profitability in the AmLaw 100 generally;
- scope mergers (adding practice areas or offices) were more profitable than scale mergers (increasing depth in existing practices and offices); and
- geographic scope mergers (adding offices) increased profitability faster than practice area mergers.

Given the level of interest in the 2003 study, we decided to expand its scope to a more comprehensive, updated study of large law firm mergers.

As in 2003, we used *profits per partner* as the measure of success, under the assumption that no one would undertake the effort and risk involved in a large firm merger in order to become less profitable. We decided to focus on large firms with publicly reported profitability data, those included in the annual AmLaw 200. We used published data except in instances where we were aware of discrepancies between actual and published figures, most likely in instances where published data was based on educated guesses, rather than reported figures. The study is based upon the most recent data available, reported in 2006 and before, reflective of performance in 2005.

We identified 117 mergers occurring between 2000 and 2005 in which at least one party was ranked in the AmLaw 200. This is an average of just over 23 mergers per year, about half the total number of US law firm mergers reported during that timeframe. Some of the mergers involved foreign firms combining with AmLaw 200 firms; no mergers of purely foreign firms were included.

First Year Profitability

We examined year-on-year increases in post-merger profitability, as measured by profits per partner (PPP).[1] Table 1 on page 9 shows the percentage of firms showing increase in profitability year-on-year. Despite the transaction and integration costs involved in mergers, and the potential disruption to productivity they create, the vast majority of mergers

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studied (77%) showed an increase in profitability in the first year compared to profits per partner in the legacy AmLaw 200 firm. Year-on-year the percentage of firms showing increases in profitability grew through year four.

Table 2 below shows the year-on-year percentage increase in profits per partner in all mergers covered. Surprisingly, despite the initial costs mentioned above, first year increase in PPP was greater than the increase reported in any of the subsequent years. Of course, not all mergers occurring in the period 2000 through 2005 report data for all five of those years. Reasons for this pattern might include:

- post-merger rate increases;
- increased institutional energy generated by the merger;
- increased discipline in conveying WIP and AR to cash prompted by the institutional change; and
- the year one "cash surge" resulting from conversion of WIP and AR to cash slackening in year two as WIP and AR are rebuilt.

First year percentage increases in PPP seem to have improved in recent years. Table 3 on page 10 shows year one percentage increase in PPP by merger year. Mergers executed in 2003, 2004 and 2005 generally showed initial increases in profitability greater than those mergers executed in 2001 and 2002. Law firms appear to have become better at evaluating and executing merger strategies to produce immediate performance improvements.

Merged Firms Are More Profitable

We compared the percentage increase in profitability of merged firms (firms executing mergers in the 2000-2005 timeframe) versus increases in profitability overall of AmLaw 200 firms, year-to-year. Table 4 on page 10 shows that in each year, merged firms showed increases in profitability greater than those reported for all AmLaw 200 firms. The differences are not great, but they are consistent, and over time they compound. They directly validate merger as a profitable growth strategy for large firms, in comparison to what might be expected if the AmLaw 200 firms involved in the mergers were to have remained independent.

Table 1

Percentage of merged firms reporting PPP increases from prior year

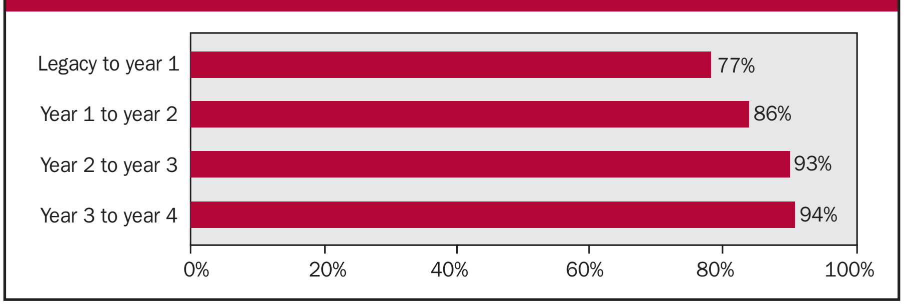
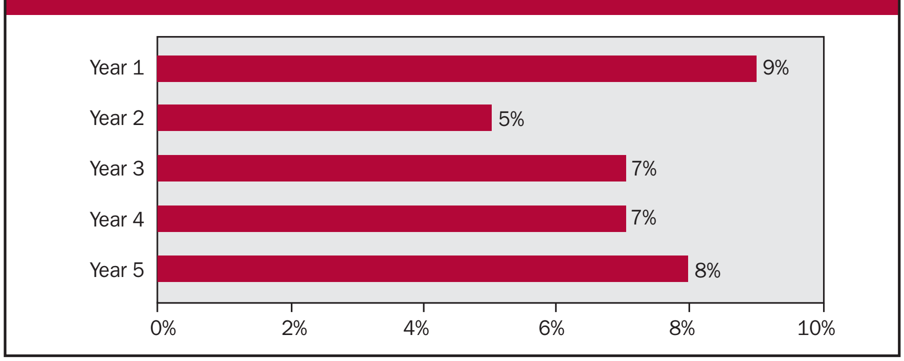


Table 2

Year-on-year percentage increase in PPP—all mergers



Profitability Based Upon Apparent Strategy

We examined the 2000-2005 mergers to determine whether there was an apparent strategy, and if so, its impact upon profitability. We looked at three categories of strategy:

- scale mergers, to increase depth in practice areas and offices;
- practice area scope mergers, to add specialized capabilities; and
- geographic scope mergers, to extend geographic reach.

We were able to identify apparent strategies in one of those three categories for 42 of the mergers. The others were primarily combinations of two or three of the strategies, or the apparent strategies could not be discerned. Table 5 on page 10 shows post-merger profitability improvement over a three-year period for mergers clearly falling into one of these three strategic categories.

Whereas in the 2003 study, scope mergers clearly performed better than scale mergers, the current study indicates that scale mergers outperform scope mergers in year one and that overall differences in profitability improvement between mergers falling in the three categories are much less than those reported in 2003. Cumulative figures through year three indicate that geographic scope mergers outperformed both practice area scope mergers and scale mergers.

One possible explanation for this is that scale mergers exhibit greater potential for immediate cost reduction due to redundancies which are eclipsed eventually by revenue synergies, resulting in greater profitability increases over time in scope scenarios. Furthermore, plucking low-hanging fruit by initial cross-selling in practice area scope mergers may occur early, but decline until institutional knowledge and familiarity

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Table 3

Percentage increase in first year PPP, by merger year

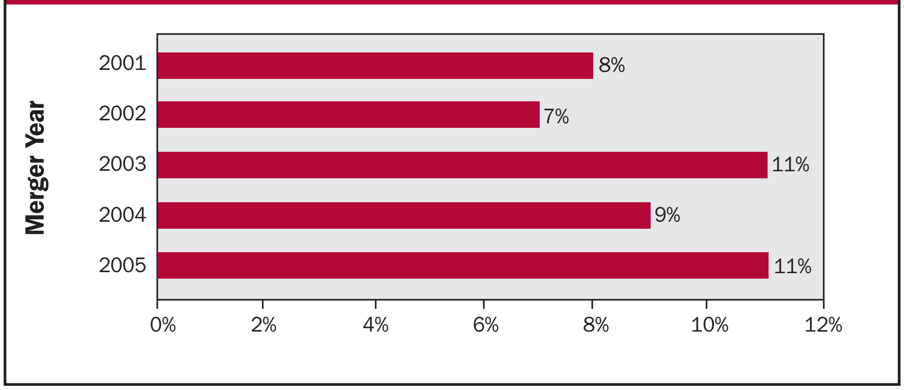


Table 4

Percentage increase in PPP, merger firms vs. AmLaw 200

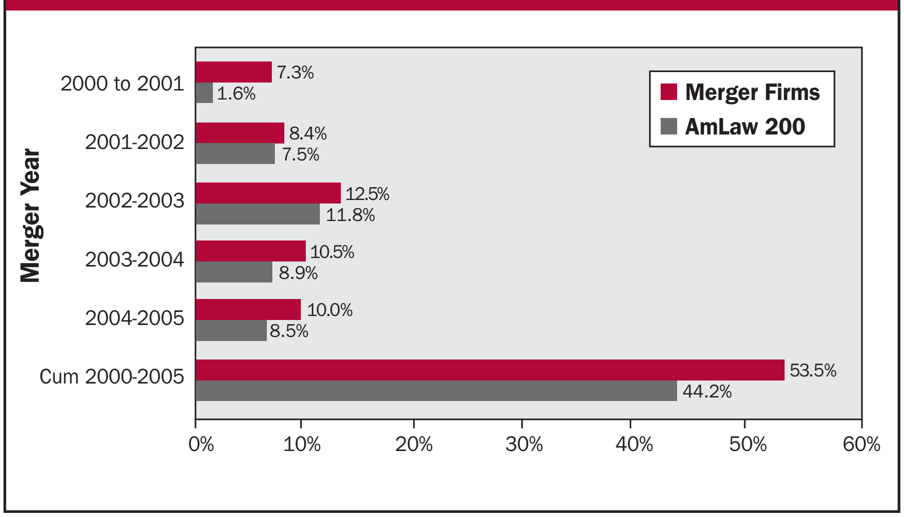
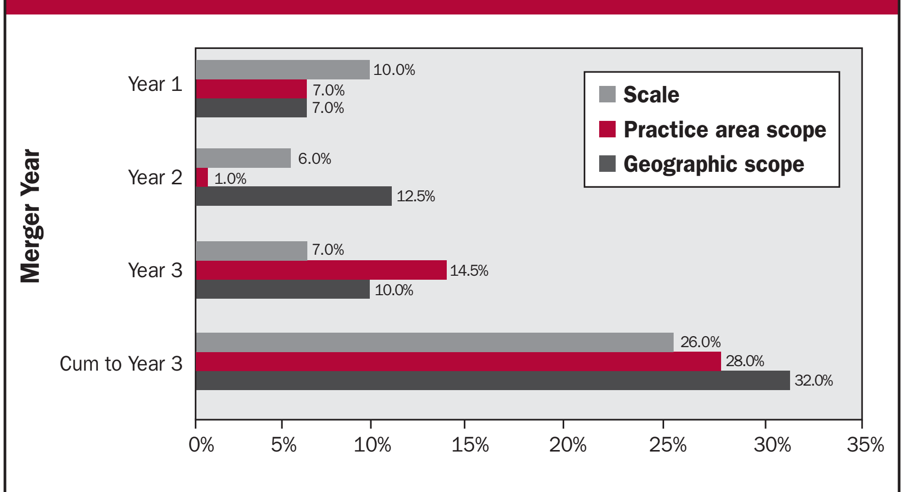


Table 5

Post-merger PPP by apparent strategy (42 firms)



accelerates synergy after year two. Overall, however, geographic scope mergers present greater potential revenue synergy than the other two strategic models over a cumulative three-year period.

Conclusions

Although the study seems to affirm the validity of merger as a growth strategy, it should not be concluded that every large law firm should embark upon this route to growth. Merger, however, appears to be a viable and successful strategy for pursuit of the strategic goals of diversification, geographic expansion or creation of depth, but obviously only if effectively conceived, executed and implemented. The study shows that:

- large firm mergers generally have been successful, in most cases from year one;
- merged firms appear to outperform the AmLaw 200, in terms of PPP; and
- although scale mergers outperform scope mergers in year one, by year three, year-on-year cumulative performance of scope mergers is better than that of scale mergers, and geographical scope strategies appear to increase profitability more than practice area scope strategies.

Based upon the evidence, it is fair to conclude that merger has proven to be an economically successful growth strategy for large law firms in the first half of this decade. ◆

[1] Profits per partner figures are taken from the AmLaw 100 and 200 surveys published each year in *The American Lawyer* magazine.

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