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

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

June 2017

Acknowledgements

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The full report and anonymous ABS survey responses are available on the LSB research pages via this link: https://research.legalservicesboard.org.uk/reports/measuring-the-impacts-of-reform/

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Executive summary

A major aim of the introduction of alternative business structures (ABS) was to allow new forms of capital into regulated law firms to improve market efficiency.

This report presents the results of our research to assess whether there are any regulatory barriers to investment in legal services. It addresses four questions:

1. What kind of investment activity has there been in ABS?
2. Is the market attractive to all sources of finance?
3. What do investors think of the legal services market?
4. Are there any regulatory barriers to investment?

Our evidence base for this report includes a survey of ABS firms, discussions with investors, experts and other stakeholders, and desk based research. We reflect on these findings in the context of our wider understanding of the legal services market.

<u>The growth in the number of Alternative Business Structures</u>

Since licensing began in 2011 there have been 950 ABS licences issued by four licensing authorities, and as of March 2017 there were 892 active licences. A fifth licensing authority – the Bar Standards Board – only started accepting applications for ABS licences in April 2017 and so is excluded from this research.

These businesses are predominantly existing legal service businesses converting to ABS status, with one in five respondents to our survey being new firms. Three fifths of ABS have less than 50% non-lawyer ownership. Just under one in five ABS are wholly owned by non-lawyers, with a similar proportion being fully owned by lawyers but having some proportion of non-lawyer managers.

<u>What kind of investment activity has there been in ABS?</u>

We looked at both use of finance and type of investments made. Our research shows that the majority of ABS firms (66%) either have already invested or are planning to do so, since they gained their ABS licence. These investments have mainly been made to hire more staff, increase marketing activity or to purchase IT. We see this as evidence of the increased scale that allowing non-lawyer ownership was designed to enable.

Overall, 52% of ABS had made an investment in their business since obtaining their licence, and 14% are planning to do so. Although only limited data is available about investment by non-ABS entities, where it exists it suggests that a greater proportion of ABS make investments than non-ABS entities. Analysis by CLC found that 52% of CLC regulated ABS had made a substantial investment in their legal business, which compared to just 23% of non ABS entities regulated by the CLC.

There are statistically significant links between higher levels of non-lawyer ownership and the likelihood of having made an investment. Larger organisations are also more likely to have invested in their business. The levels of investment activity also vary by the type of organisational structure. For all types of ABS, 70% of limited liability partnerships surveyed have made an investment, compared to 40% of limited companies.

Are ABS attractive to all sources of finance?

Our survey shows ABS firms accessing a wide range of sources of finance, and only a small proportion of ABS indicating difficulties in accessing finance. The most frequent source of funding for investments was business profits or cash reserves, which were used by 49% of those who had invested in their business. Just over a quarter of investments were solely funded using a loan from a bank, and a quarter were solely funded using the business' overdraft facility. External sources of equity finance accounted for only a minority of investment funding sources either as the sole or joint source of investment funds, and only 12% of ABS had used any form of external finance.

Partnerships are more likely to use debt funding for finance, with 55% using loans or overdrafts, but none had used external investment. Companies limited by guarantee had the highest proportionate use of any form of external funding, with 24% issuing shares, investment from private equity, or becoming a subsidiary of another company.

What do investors think of the legal services market?

According to the investors we spoke to, the legal sector is seen as a 'sleepy' market with opportunities for investors to grow their investment capital by improving efficiency within the business itself. They appear to have concerns about the ability to exit the legal sector once their investment has matured, although there are some examples of private equity investors having sold on their investment and exited the sector.

Except perhaps in the personal injury sector, it would appear that bank lending is a substitute for external capital. For the firm this means they do not have to cede ownership control of part of their business. In addition, there is a view that many firms do not present financial information in the ways investors expect and/or have a weak grasp of the value of their businesses. This might explain the investor's perspective of the legal sector as being reluctant to seek investment from private equity firms, and reports of investors struggling to find appropriate firms in which to invest. While the overall size of the market and the scale of businesses operating may limit opportunities for some investors, we think that cultural norms, governance, and non-commercial financial management practices in some businesses are likely to be more important factors.

Are there any regulatory barriers to investment?

Only 6% of ABS identified some aspect of legal services regulation that prevented them accessing finance. Nor does the cost of legal services regulation appear to be a barrier. Further, while there have been issues in the past with the SRA's licensing process these seem to be historical, and do not currently appear to be acting as a barrier to external investment. However there is anecdotal evidence of some areas of regulation causing concern to investors. These includes restrictions on ownership and picking up liabilities for historic complaints and insurance claims.

Only 1.5% of ABS identified some aspect of wider regulation that prevented them accessing finance. The regulatory barriers to investment cited by the investor and investment consultant we spoke to relate mainly to wider regulatory and governmental activity, particularly in relation to personal injury reforms. While it is not possible to quantify the impacts of these regulatory barriers to investment in legal services, it is reasonable to conclude that they have had a negative impact on external investment to some degree.

While there are clear policy objectives to these wider regulations, we have not found any assessment of the possible negative impacts on investment in the legal sector.

The potential link between investment and enabling better access to legal services is well-rehearsed elsewhere. However, investment remains an under-explored area of research and generally licensing authorities have not used their data to understand trends in investment and financing. The Council for Licensed Conveyancers has taken a lead in seeking to understand this aspect of the market, and we encourage other licensing authorities to replicate this activity.

Overall conclusions

The low level of external investment seen to date may be a symptom of weak competition in the market overall, as found by the Competition and Markets Authority market study, LSB's Market Evaluation and the joint SRA LSB research revealing that levels of innovation are not increasing. The dynamics of competition create incentives for suppliers to increase productivity through innovation, which lowers costs and hence prices through time. This is likely to involve taking a different approach to delivering a service, or developing new services completely. In the absence of strong competition, there is little impetus for law firms to take the greater risks (and rewards) involved with using external capital. Until these incentives change we may not see significant growth in the use of external capital by ABS firms.