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Growing Your Practice: Build or Buy?

By Joel G. Block and Nanette Miller

The consideration of growth strategies is a vital, ongoing process for every law firm, not something to be addressed only at the partners' annual meeting. A firm that does not continue to grow will soon begin to shrink and eventually die. Once a firm realizes that it must grow to survive, the question becomes how: to build or to buy?

This decision has great strategic, financial and emotional impact on a practice. It goes right to the core of the practice and is personal because each firm is unique in terms of its culture, tolerance for risk, existing skills, market environment and vision for the future. To determine which approach is best for specific practices, consider the pros and cons and financial implications of building vs. buying.

Build or Buy?

Once a firm recognizes the need for growth and has identified current vs. desired components (practice areas, regional offices, number of partners, etc.), the cost effectiveness of buying versus building hinges on four key areas.

• ***Timing.*** Purchase is simpler and less time consuming than internal growth because it means acquiring a ready-made solution. The rewards should be immediate.

• ***Fit.*** The danger of cultural misfit, with possible dire financial consequences, is greater in a merger or acquisition. When law firms groom associates to fit in over time, the risk is mitigated. "The classic mistakes firms make in lateral hiring or acquiring practices are betting on synergy, failing to integrate people and not paying attention to detail," says Larry Braun, chairman of the corporate practice group of Sheppard, Mullin, Richter & Hampton LLP, a 350-person law firm with seven offices in California.

• ***Risk vs. return.*** A practice area that is in a new geographic area may involve a higher risk, commanding more than a marginal return. A low-risk practice or one that is not particularly "hot" will yield a lower return. It's a matter of balancing profit and strategic motivation.

• ***Infrastructure.*** Growth implies adding information systems, technical support, software capacity, credit and collection personnel, human resources and increased access to external professionals. If funds are not readily available, what is the cost of obtaining them? Is it more cost effective to borrow or to use internal funds? Is it worth the investment?

For many firms, the way to grow may be to buy and build. "Lateral hiring and acquiring another firm allows you to gain expertise quickly," says Mr. Braun. "Building from within through new associates takes longer, but you need to do both."

Planning for Growth

The biggest mistake a firm can make is not having a formal plan for growth. "Don't let growth happen by accident," says Mr. Braun. "It requires an integration plan. Law firms and other special service firms are used to hiring new people, giving them an office, turning on a computer and saying, 'Go do it.'" Firms should take plenty of time to integrate not just the new partners, but also their clients through programs that introduce them to the expanded services and expertise they can now access. "For example, in an acquisition our firm recently made, I personally spent over a month and a half planning the details of the integration," Mr. Braun says.

"Lack of planning usually results in failure," says Tom Drucker, president of Consultants in Corporate Innovation in Marina del Rey, Calif. Mr. Drucker is a consultant to a variety of businesses, including law firms. "For example, when a law firm acquired a practice based on synergy of client lists, but without paying attention to personalities, it resulted in the meltdown of the entire firm. An East Coast firm's acquisition of a regional firm resulted in failure because it failed to take into consideration the amount of time it would take to manage the acquisition. Another firm added a practice area without analyzing the marketplace. The area turned out to be in low demand, and the investment did not pay off."

Even if growth is not an immediate goal, plan early in order to take advantage of opportunities instead of reactively responding to crises. It pays to be prepared when it becomes necessary to take quick and decisive action to establish a presence in a new practice or geographical area. That's why the growth committee must be a permanent, continuously staffed committee. "Planning is a process, not an event," says Mr. Drucker. Therefore, management takes action on a monthly, quarterly and annual basis, using the plan as a guideline for working day to day, week to week and month to month.

The financial and cultural implications of any acquisition require equal attention. “No plan is of any value unless it is looked at anew and refreshed every 12 to 18 months because the underlying assumptions may change,” says Mr. Drucker. Growth can be predicted based on certain activity levels, given discipline and consistency to measure trends over time and plan accordingly. Key indicators in tracking growth include the firm’s internal capacity for growth, its ability to build long-term client relationships, and a return-on-investment analysis incorporating tangible economic as well as intangible cultural factors. An apparent lower return on investment may bring more value in the long run because of an optimal cultural fit.

A Financial Planning Model

Assessing the financial implications of buying vs. building is a five-step process.

➤ ***Step One: Assess core competencies.***

The first step in developing a financial plan is an assessment of one’s current core competencies. Which practice areas are the most lucrative? Which professionals have the most potential for growth? Which less lucrative practices can be pruned to free up funds for more profitable ones? Evaluate how much each area is contributing to the bottom line and how much it is expected to contribute in the future.

➤ ***Step Two: Build a model.***

A model based on past experience and current costs will lay a foundation for a what-if game. It takes into account the number of partners and professionals needed, cash flow, profit and loss, personnel and infrastructure costs, and the length of time until revenue can be expected. The idea is to build a formula for how the business works currently and then extrapolate what is needed for the planned addition based on cost per attorney, support staff, square footage, equipment, furniture, communications (Internet, phone, etc.), etc.

“In planning, infrastructure is somewhat more predictable,” says Mr. Drucker. However, infrastructure needs may vary widely between different practice areas. A thorough understanding of current resources for current practice areas increases predictability in augmenting or enhancing these resources for new demands.

➤ ***Step Three: Identify financial resources to cover the cost of growth.***

Is internal capital available to fund growth, such as a portion of the partners’ salaries? If not, identify a short-term or long-term bank loan considering the implications of the repayment schedule, the revenue the new business will generate, when that revenue can be expected and the payment terms on that revenue to ensure that cash inflow matches outflow.

➤ ***Step Four: Consider the ripple effects.***

The most costly mistake law firms make in growing is underestimating the ripple effect of their decisions. For example, different practice areas have different accounts receivable cycles. If a firm is adding a bankruptcy or financial recovery area, it must be prepared to wait 90 days or longer for the processing of its fee applications. Existing cash reserves and traditional accounts receivable lines of credit may be inadequate in financing such a new business.

➤ ***Step Five: Plan for taxes.***

While tax considerations take a back seat to the ability to increase cash flow, they are another reason for planning. Tax ramifications can be complex and quite punitive if the firm gets it wrong. Unleveraged growth can mean higher taxes while building from the inside may actually reduce taxable income. It’s best to consult with a CPA in these matters, but remember that the CPA requires a complete picture to give proper advice.

A Fool for a Client?

Several sources can provide guidance in developing models for growth:

• The firm’s own M&A practice is an often neglected resource.

• A CPA can help build a flexible financial model.

• The bank can advise on credit lines and provide general guidance based on the current market and on its experiences with other firms.

• The firm’s recruiter can help assess the talent pool and current prices.

• A facilitator or strategic planner can keep the planning effort objective and on track.

Attorneys frequently say that only a fool has himself for a client. When a firm is not experienced with growth, it’s best to get help from other professionals. Besides, sometimes it’s healthy for a service provider to remember what it’s like to be a client.

It Pays to Be Prepared

The accounting firms that are profiting from Arthur Andersen’s missteps today are those that were prepared for growth. They were ready to respond instantaneously and pick up new clients, most likely because they had a plan and kept their eyes open for new opportunities. The lesson for law firms is that growth is not a one-time problem with a one-time solution; it is an ongoing process. Firms that don’t buy into the concept of continuous growth management will pay the ultimate price sooner or later.

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