Stocks & Services

Can listed professional services
firms find long term success?

There is an argument that professional services firms simply cannot succeed as listed entities.

It's a generalisation, but not mere conjecture - it is a view based on evidence. RSM Tenon, ILH Group, Stockford, Crowe Horwath (in Australia) and Vantis have all gone into administration or re-privatised after a run of poor results post listing.

So, with this somewhat chequered history in mind, why are more and more firms, in both Australia and the UK, seemingly considering a stock market listing? Indeed, over the last year Spruson and Ferguson in Australia has listed on the ASX and Gateley in the UK has listed on AIM.

What is going on?

It seems fair to assume these firms have been emboldened by the success of Slater and Gordon – despite recent a hiccup, its share price has more than tripled since it went public in 2007.

The burning question for any firm seeking to replicate this success is "How has it been achieved?" Simply listing and hoping to ride on the coat-tails is not much of a strategy – surely it's better to understand the secret of Slater and Gordon's success? Is it simply strong leadership and sound strategy or is there something more to it?

To understand that, we first need to consider why firms list and why listing has so often gone awry in the past.

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The advantages of the partnership model are well known.

There's ability to own part of the firm, to have control over both your own and the firm's destiny. And there's the chance to share in the profits of a business run by a group of professional owners rather than external investors with their own agendas. But like all business models, it has its downsides – in this case, setting limits on ambition.

That is, partnerships have traditionally found it difficult to fund acquisitions and investments. They have limited financing options and, of course, investments have to come out of Partner profits, which many are not willing to stomach even if it is of long-term benefit to the firm.   As a result, a serious, large-scale acquisition strategy is often out of reach.

This is one of the reasons why a listing often looks a tempting proposition. External investment gives firms access to the kind of serious capital that transforms acquisition horizons – listed firms can fund acquisitions of a size and scale that are beyond a traditional Partnership.

For example, Slater and Gordon has recently announced an agreement to acquire the A$1.2 billion Quindell PLC's Professional Services division. How many traditional law firms could make such a bold play?

Fraught with risk

Although this access to the capital required to fund acquisition is one of the obvious attractions of listing, it is only a means to an end, not an end in itself. Indeed, a listing driven solely by appetite for acquisition is fraught with risk.

Many of the firms that have struggled as listed entities went on acquisition sprees post IPO. This initially powered huge growth and increased revenues, which were well received by the markets.

However, problems already lurked under the surface - access to funds was not paired with clear strategic thinking and, as a result, some acquisitions were less than prudent.

Over time, they did not integrate well or return the predicted profit and when profits fall, Partner and Principal earnings diminish and it is only a matter of time before people start heading for the exit. Profit warnings followed and, ultimately, the firms failed.

Having to deal with such fall-out is hard for any firm, but the issue is compounded for the listed firm as it all plays out in the public eye. Traditional partnerships can deal with issues and large-scale change in private and often weather the storm.

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But listed entities are bound by quarterly reporting rules, which become a procession of bad-to-worse news – and that kind of downhill momentum can be hard to reverse.

This is one of the reasons Crowe Horwath in Australia has recently been delisted. Following acquisition by Findex there is a lot of work to be done to bring the firm back to its previous standing. It would be impossible to make these radical changes whilst in the public eye, and whilst doing the firm's fiduciary duty to shareholders, which is by nature short termist.

Personal gain?

Another obvious reason to pursue a listing boils down to personal gain rather than the growth of the firm. But again, although the initial upside for Partners is potentially significant, there remains a need for longer term thinking if the firm is to be successful post-listing.

Take Spruson & Ferguson for example, whose recent IPO netted the 19 Partners a reported A$160 million between them - little or none of this influx was retained in the firm for growth. Who wouldn't want an A$8.5 million payday? But once again, the risk is that the absence of a strategy simply stores up big challenges to be dealt with later.

A model for success?

Despite all this Slater and Gordon, Shine Lawyers and H&R Block have all achieved successful listings – so what can we learn from them?

For one thing, these firms all focus on the business to consumer market - highly commoditised, low value work that is ripe for disruption through technology and alternative business models. Is this is a coincidence?

On the contrary, it seems these firms may share some winning characteristics when it comes to a successful listing – and have been smart in making them really count.

First, high volume consumer work is much more likely to be tied to the firm and brand rather than an individual Partner, so there is less risk of acquiring a firm and then watching a large chunk of your acquisition (both people and clients) walk out of the door.

This is one of the reasons why acquiring firms working on high volume, low value work tends to deliver stronger ROI compared with deals to buy more complex professional services firms focused on areas such as Consulting or Corporate Law.

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Second, commoditised work can be made more profitable through the use of shared service functions, the cloud and standardised practices.

These pre-existing levers offer a powerful means to drive profitability post merger - for both parties - ensuring a strong return on investment for the acquirer, an attractive reason to be acquired or to merge, and a genuine incentive to integrate once the deal is done.

And third, the Partners and Principals of these firms gain a significant amount from these firms' brand given their scale and continuous growth. As a rule, that means that, as long as the culture stays strong, there are few reasons to leave.

This all suggests that it is possible to successfully list a professional services firm – but listing remains a risky move for any firm outside of commoditised high volume markets.

That is, firms in commoditised markets need scale to succeed, and they need it fast - so there is an obvious reason to list. The imperative for firms outside this space is less clear-cut.

In a more specialised practice focused on high end consulting and advice to business, success is about quality not quantity.

Scale is useful but the leverage model means you don’t necessarily need vast scale to be a success. What’s more, specialised work is less conducive to a listing as the type of returns investors are looking for simply are not achievable in a sustainable manner - hence the huge growth these firms often deliver in the early years of listing, followed by a sudden collapse as the house of cards falls down.

The fact that Gateley has recently listed on AIM in the UK is very interesting - this is a full service firm trying to do what no other full service law firm has done before, and that raises a host of questions.

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Whilst the initial returns look good (£30 million raised on day one, netting the firm £5 million), what happens when the share price drops?

Is this a model that is sustainable or is it simply a short term win?

If the firm is going to embark on an aggressive growth strategy will it be able to integrate individuals and firms in a way that is culturally aligned and profitable or will it go the way of those who have tried and failed before?

Perhaps the biggest questions of all are whether Gateley will learn from the mistakes of the past, and whether it can take anything useful from the success of listed firms in commoditised markets.

There is a first time for everything and, if Gateley heeds the warnings from history by shaping a post listing strategy designed to balance sustainable growth with shareholder value it has the chance to be a genuine pioneer.

We shall see…

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