WHITE PAPER

Today’s mergers and acquisitions industry: Prepare your firm to take on and win more M&A business

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A law firm is nearly as central to a merger as the buyer and seller. This is especially true today: M&A (mergers & acquisitions) is becoming a greater challenge due to rising interest rates and stock market volatility. More than ever, having a law firm that skillfully executes its responsibilities is key to getting the deal done.

Consider a law firm as being a client's most valuable utility player throughout the merger process. If the firm is working for the buyer, lawyers will run due diligence on the potential acquisition, looking for such red flags as ongoing/potential litigation or unforeseen debt obligations on the seller's balance sheet. Lawyers will advise on how best to structure the deal, how best to minimize tax exposures, how to comply with federal and state regulations, or how to secure valuable assets like the seller's intellectual property.

As for sellers, their law firms work to ensure that the company sells at the highest multiple that it can get, given market conditions. They look to protect their client from onerous or too-stringent deal terms, and, if it's of importance to seller ownership, ensure that seller employees will be protected or at least guaranteed a measure of stability post-merger.

Stability isn't what the market is experiencing at the moment. So far, 2023 has been a volatile time for M&A. The record low interest rates and (relative) equity market stability that defined the 2010-2021 period are long gone. Dealmakers are now contending with the fastest-rising rates in decades and whipsaw changes in market sentiment, driven by everything from inflation fears to the war in Ukraine to bank failures.

Understandably, this wariness is slowing deal volume. And there's a new level of reality in terms of company valuations. "Valuations are becoming more reasonable," says Raees Nakhuda, Senior Counsel for M&A at Thomson Reuters. "Obviously, debt is more expensive now, but at the same time, a year and a half ago, valuations for companies were through the roof. So you were paying a 10 times multiple for a business, whereas now people are realizing that everything was being overvalued. That while revenue is still important, people are looking a little bit more towards profitability and the synergies that they can build as a result of a transaction."

In many ways, a "back to reality" sentiment is a positive for a buyer. Even though the debt markets are more expensive, "for entities that are flush with cash, there's a ton of opportunity now because you have these businesses that have more realistic valuations," Nakhuda says. "Now is probably the best time to make deals if you're interested in making them and you have the money to make them, because you can buy companies for reasonable prices."

With this shift in the M&A environment, a skilled law firm could make the difference as to whether a deal succeeds or not. An M&A lawyer's role is to make sure their client's interests are properly represented in a deal structure. They sound out the purpose of an acquisition, looking to ensure the purchase will add strategic strength to their client, rather than being an opportunistic deal that could be a long-term drag on the client's operations. And in the future, law firms will need to do all of this at less cost to their client, or risk losing out on business.

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ADAPTING TO A CHANGING WORLD

The M&A market weathered COVID-19 without sustaining too much damage, and the immediate post-pandemic era was even a boom, with substantial new deal volume throughout 2021. It's the longer aftereffects of the post-COVID era, such as inflation, higher rates, and their repercussions throughout the markets (such as the bank run on Silicon Valley Bank), that have rattled dealmakers.

Through 2022 and so far this year, Am Law 100 firms in particular have seen demand decline, at times precipitously. According to the [2023 Report on the State of the Legal Market], on a year-to-date basis through November 2022, overall demand contracted by 0.1%, compared to the 3.7% growth rate in all of 2021 (which was bolstered by the dip in 2020). At the same time, many firms have added lawyers at a hearty pace. These competing trends are a potentially volatile mix: declining productivity and client demand set against higher direct and overhead expenses.

Also mentioned in the report, "this disparity is primarily attributable to the fact that the current downturn hit high-value corporate and transactional practices (e.g., capital finance, M&A, and private equity) particularly hard, as corporate clients slowed or postponed deals in the face of economic uncertainty. However, the numbers also point toward another trend that has been underway for some time — the noticeable re-segmentation of the legal market as more price-sensitive practices have moved down market to smaller firms capable of delivering quality services at lower rates."

Because the drop in activity has been substantial in transactional practices like M&A and high-end corporate finance work, Am Law 100 firms have been hit hard. By contrast, midsize law firms are more competitive in litigation, labor & employment, and intellectual property, posting substantial growth in these areas. Indeed, midsize firms were the only market segment with positive demand growth (in their non-transactional practices) in second-half 2022.

This leads to the expense factor: law firm expenses are at their highest average growth rate since 2008. What's fueled this spike is, in some part, associate compensation. Associate pay has jolted up in the past two years, reflecting an industry-wide scramble for talent. While any negative impact of rising expenses got offset last year by firms raising their rates significantly, a law firm hoping to continue rate increases in 2023 will likely face greater resistance from clients. There's already evidence of a slowdown in client payments and an unseasonal decline in realization rates in the second half of 2022.

Many law firms are in a tough spot at present — a situation that could extend well into 2024. They're pressured on the cost front by smaller firms. If they're unable to continue rate increases, they could need to make difficult decisions, such as reducing headcount. And one X factor is the chance of a recession in 2023. That said, many analysts note that current conditions don't resemble those of the Great Recession in the late 2000s, and so a recession, if it comes, will be shallower than the previous one. Further, a modest downturn could boost M&A activity, as it will present a greater opportunity for buyers looking for quality bargain acquisitions.

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SHIFTS IN M&A SENTIMENTS

In periods of uncertainty, a natural instinct for a law firm is to hunker down, to play it safe, cut costs, focus on core competencies. This strategy is understandable, as it's how many firms have survived previous downturns. But there's another strategy that law firms could pursue.

This entails making greater investments in technology with the intention of radically changing operations and internal workloads. By using technology to winnow down the "paperwork" side of their business, law firms are free to choose different priorities. They may try more experimenting, go more head-to-head with lower-cost competitors. They can use a volatile time to become more nimble and flexible, rather than just hoping to ride out the storm.

This adaptation comes as businesses are also changing their priorities in the face of post-COVID uncertainty. A recent survey of over 1,200 business leaders by **Eversheds Sutherland** found that more than seven of ten business leaders surveyed are now focused on a new "M&A triarchy" — talent, tech, and trade.

When searching for a target, many potential buyers want a company with a distinct brand and an enviable public reputation, "perhaps showing the extent to which dealmakers recognize the impact of transparency and the value of positive brand advocacy," as Eversheds Sutherland notes.

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Taking on the triarchy

This new M&A triarchy also presents a host of opportunities for law firms.

TALENT.

As per Eversheds Sutherland, 72% of business leaders see talent retention and acquisition as being critical to their business strategy over the next year. About 62% said they believe the so-called "Great Resignation" is a catalyst for deals. Hence the growth of "acquihiring," in which buyers acquire a company to bring the seller's employees on board. Talent poaches are particularly appealing in such sectors as life sciences and energy, when a company wants to buy its way into the sector via a merger.

How law firms can add value: If talent is at the heart of the deal, holding on to it post-merger is obviously essential. Both buyers and sellers could fear a mass exodus of employees after the deal, especially if there's a time gap due to a slowdown in negotiations or a rival bid for the seller. So, lawyers could push for such closing conditions as an agreed-upon staff retention percentage. If, for example, a majority of seller staff is no longer in place at closing, the deal could be terminated, or other options invoked (e.g., a lesser earn-out or a lower purchase price).

TRADE.

Supply chain disruption and trade sanctions are making globalization less appealing. About 68% of surveyed business leaders said greater supply chain resilience is going to be a strategic M&A priority and about 60% said supply chain dislocation specifically due to the Ukraine war is making vertical integration more critical.

How law firms can add value: If vertical integration is foundational to the buyer's plans, the seller needs to be in shape, ready to be thoroughly absorbed. Lawyers must perform vigorous due diligence to ensure that this will happen, and on a fast timescale. What are the potential obstacles that could prevent this? Are there real estate issues? Tax obligations? Could regulators object? These scenarios should be gamed out as soon as possible during the deal process, and hopefully addressed before closing.

TECH.

Much like talent, acquiring technology is a strategic driver for deals. For companies that have been lagging in terms of recent tech developments, they may acquire a start-up to get up to speed. Eversheds Sutherland found that 74% of surveyed business leaders say M&A is important in terms of bridging technology gaps in their organization. Many also said that acquiring a new technology could increase their purchase price.

How law firms can add value: If technology is driving a deal, what is the state of that technology? Is all of its related intellectual property secured? Are vendor contracts up to date? What are its maintenance costs and procedures? Are specific seller departments necessary to keep the technology running smoothly? Lawyers should spearhead efforts to get answers to these questions, and to get solutions in place if there are any concerns about how the tech will perform post-merger.

How law firms can win more M&A business

Given how the M&A market is changing, how should law firms respond?

Winning more business in a challenging deal environment, in the face of greater amounts of low-cost competition, will take more than reputation and client relationships, though those are of course important. More and more, it's about what value a law firm adds to the merger process. What can lawyers do to make a deal go more smoothly? Even more vital — what advice can they provide before the deal negotiation even begins?

One way is to devise sound, thorough processes for their clients when it comes to potential mergers. Well before they make first contact with a potential target, your client should know the why's and how's of the potential transaction. That is — *why* am I pursuing this acquisition? And how can it be done efficiently, quickly, and at as low a cost as possible?

To find out, law firms can research, draft, and implement an **"M&A blueprint"** for their clients. This gives clients a strategic plan to determine whether doing a deal is in the buyer or seller's fundamental interest. It's meant to ensure that the potential deal isn't just an opportunistic lunge at a low-hanging asset, one which could present integration troubles down the road for a buyer.

The aim is for a client to have a reliable blueprint as to how they can best proceed, whether with a specific company or with a specific sector they're exploring. How can a law firm use this blueprint to structure their own deal advisory to a client? Here are some ways:

? WHAT ARE THE DEAL LIMITS?

Lawyers can help define a client's boundaries. This could be a limit in terms of how much the client is willing to pay (or, if they're a seller, how low of an offer they will accept). It could be setting limits as to the potential acquisition's operations, such as a bottom or top number for employees, offices, or products/services. It could be a cut-off point for seller debt obligations.

? WHAT ARE THE STRATEGIC GOALS?

What in your client's current operation does the potential deal improve or augment? A particular market sector? A product line? A specific type of hire (for example, if the buyer is looking for quality tech talent in an area it's not involved at present)?

? WHAT'S THE BUDGET?

What's the client expectation for costs needed to assess, purchase, and integrate the seller's operations?

? WHAT'S THE TIMEFRAME?

What types of operational changes and capabilities are needed to integrate the new assets? This is particularly important in a deal done to acquire a particular type of technology that the buyer lacks. When can they expect to put it to work?

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Law firms also are contending with a growing trend in which clients are cutting back on their M&A expenses. "Internal budgets are getting tighter and tighter on M&A deals because external counsel fees go towards transaction costs for a deal, which gets folded into the integration cost for the business," Thomson Reuters' Nakhuda says. "So if we're spending $1.5 million or $2 million on legal fees, that's a big hit on a transaction. The legal fees don't really drop depending on the value of the transaction, because the work is pretty much the same. So you could get a $50 million transaction or $100 million transaction where legal fees are still $1.5 million, which again, if you're looking at it as a proportion of deal value, it's way too high."

Artificial Intelligence technology: Cutting costs, reducing burnout

Here's where an adept use of new technologies, particularly those employing artificial intelligence processes, could mean the difference between winning and losing a client opportunity.

"If law firms are able to use technology to reduce those costs, it's going to be beneficial in the long run for their relationship with their client and their ability to get new business," Nakhuda says. "For instance, a firm may send out an RFP (request for proposal) each time and say, 'give us an estimate based on this transaction.' And if firms are using technology like Document Intelligence, they can cut down on diligence costs by 50%. All of a sudden they're using technology to reduce labor costs and now they're able to offer you this transaction much, much cheaper than their competitor."

AI is also a means to keep a law firm's talent engaged, and to reduce junior lawyer burnout. One reason that a deal process could hit a snag is that the lawyers who originally were working on it have departed. Or they have been so caught up in the "grunt work" side of diligence — spending weeks going through a document pile, for instance — that they have no time to provide more valuable insight into how to make the deal work for the client.

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Document Intelligence

Thomson Reuters® Document Intelligence enables law firms to speed up due diligence reviews without sacrificing on accuracy — if anything, firms greatly enhance the level of detail in their reviews as they reduce processing time.

AI technology like Document Intelligence is fundamentally changing the nature of legal work. Law firms that fail to adapt will, more and more, risk coming off as a costlier, yet more antiquated option for clients.

For one thing, the difference between pre- and post-AI technology is stark, in terms of cost and efficiency. As Nakhuda says, "instead of having a junior associate or a team of junior associates charging $500 an hour and spending a week or a week and a half viewing contracts, you can have it done much faster." One example: Nakhuda recently uploaded 17,000 documents in roughly an hour, then received the output in three seconds. And this wasn't just an overall summary of the documents. It was detailed summaries of each contract based on pre-set parameters.

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"For example, I would check off 'change of control' and 'assignment.' Document Intelligence would then print out a summary for that," Nakhuda said. In the past, "you would have a junior associate or a team of junior associates doing it, except they would be doing it manually. They would be going through each contract, copy/pasting the provision and putting it into a document and then going to the next contract and the next and again. If you have thousands of documents, that's going to take a lot of time and energy." Thanks to AI, the time and energy required to complete due diligence reviews is much less, giving lawyers more time to focus on other work.

Other Document Intelligence users have experienced similar quantum leaps in productivity. One noted that as they had been using paper documents a mere six weeks before a project started, they expected the project could take up to two years to complete. Using Document Intelligence, the client got the project done in two months. "What would easily take 20-25 days, my team can now knock out in just a few days."

Another noted that it had once taken over a month for employees to find a 'consent to assign' — physically looking through every single document. With Document Intelligence, this only took two minutes.

This rapid compression of diligence time, and the vastly improved means of organizing and analyzing data, will enable a law firm to stand out in M&A advisory. All of the skills that the firm needs to bring to bear in a merger — such as comprehensive analyses of a deal's potential and examining and listing all of its potential downsides — can be done faster, more precisely, and more cheaply using AI technology.

The M&A market of the past decade was one of steady growth, substantial deal volume, low interest rates, high valuations, and substantial cross-border activity. Looking at the market today, that now seems like a lost world. While favorable conditions will no doubt return to dealmaking, what's more unclear is whether some law firms will resume their previous roles with clients, in terms of the amount of M&A advisory business they receive. Unless firms adapt, **utilizing new technology** to develop new, more valuable roles for legal advisors, this may not happen.

The challenge presented by lower-cost alternative legal providers, and the vast potential of AI-driven technology to bulldoze costs and skyrocket productivity, is changing the nature of the M&A game. The question for many law firms is how to play under these new rules, and most of all, how to win.

Ready to take the next step?

See how your firm can improve your M&A due diligence process with AI-powered document intelligence and contract analytics:

legal.thomsonreuters.com/en/c/document-intelligence