Law Vision

Creating Competitive Advantage

Special Report Article

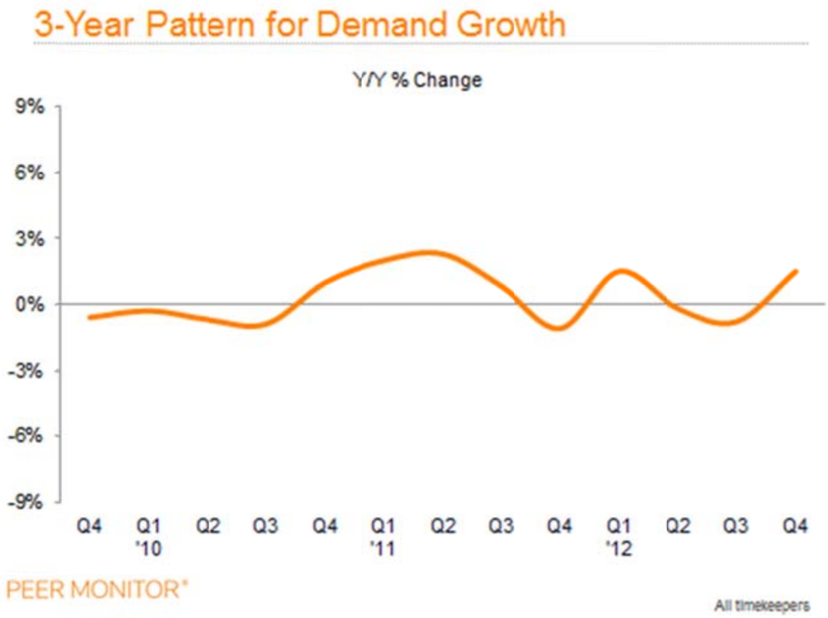
"Winners and Losers"

By: Joe Altonji and Mike Short

Famous radio broadcaster Paul Harvey used to entertain his listeners from the 1950s through the 1990s with seemingly simple tales that, upon deeper analysis, revealed a much more complicated and elaborate storyline. Once he was done weaving his tale and delivering a surprise ending, he would sign off by saying, "and THAT…is the rest of the story." Mr. Harvey's signature sign-off inspired us to take deeper look into the "rest of the story" as it relates to the growth/decline in the demand for legal services over the last few years.

Law firm management is – at its core – about aligning the capacity to *supply* legal services in a firm with the *demand* from clients for that firm's services in a manner that produces an appropriate level of profitability for the owners. There's a basic law of economics at work here and to balance these two factors most effectively, firm leadership needs to understand how the demand for legal services is changing (growing or declining) both at the firm level and within various parts of the firm's practice. In this article we will focus on firmwide demand trends.

Here's our seemingly simple *starting* theme – working with our friends at Peer Monitor we know that, on average, the growth in demand for legal services (measured in total hours billed by all timekeepers) was up a mere 0.5% from 2011 to 2012 and has generally seen little changed since the market experienced a major drop-off in demand at the beginning of the financial crisis. Year-over-year percent changes in overall demand (based on comparisons of total billable hours recorded by all timekeepers in each quarter) for the past few years is presented in the following chart, which shows basically no net change in overall demand during the study period.

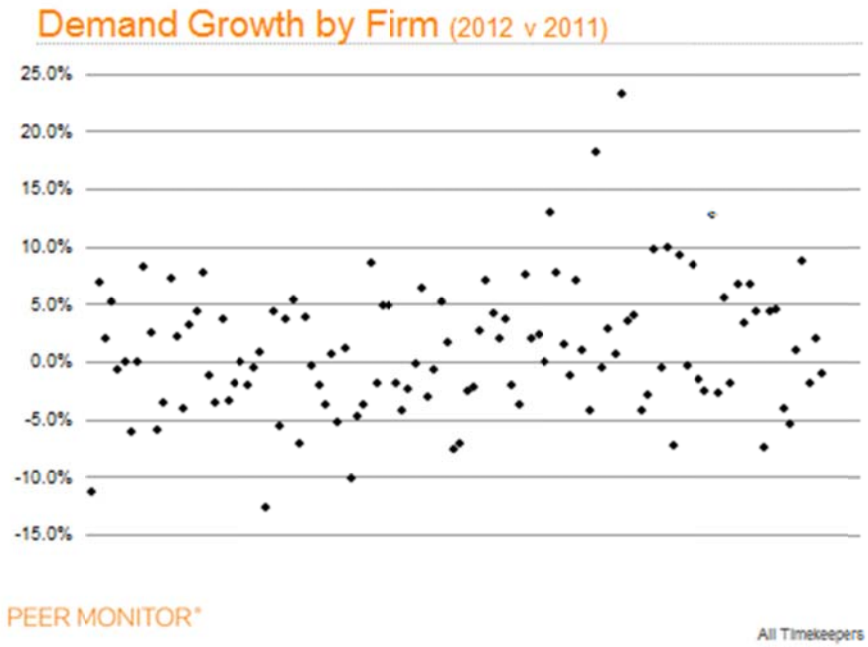


Source (all data and charts): Peer Monitor, a Thomson Reuters service that provides monthly comparative financial information for participating law firms (http://thomsonreuters.com/products_services/legal/legal_products/a-z/peer_monitor/),

One could infer from this trend line that the legal market is in a fairly steady, stable state wherein all the competitors are acting in a largely consistent and uniform manner. These trend lines suggest that the situation is calm, consistent, without outliers, and devoid of volatility.

Nothing could be further from the truth.

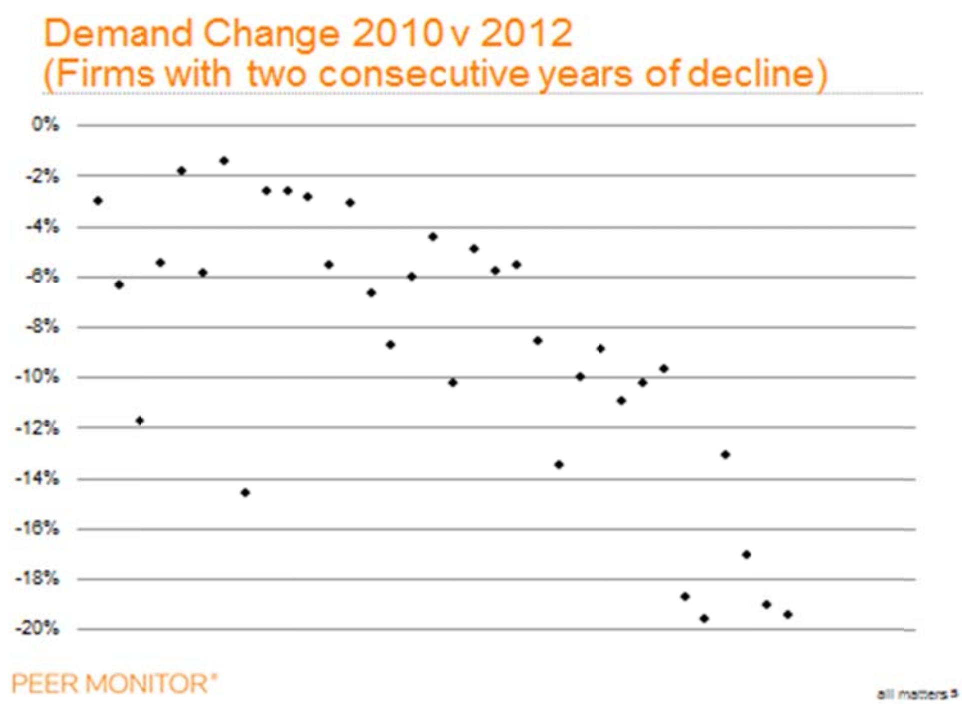
Experienced statisticians know that the distribution of data points around an average is vitally important information in any data-based analysis. In fact, that distribution may contain far more information than any single statistic – the average, in this case. With this concept in mind, dear reader, we now offer the *rest of the story.* This average growth rate is not derived from all firms basically holding on to their business or growing just a little. In fact, the distribution of individual law firm performances around the 0.5% average growth rate is actually quite broad and dispersed, as seen in the individual data points used to create these averages (see the following chart, wherein each data point represents the growth/decline experienced by one law firm in the database):



This distribution pattern, which may look random, carries within it a vitally important message. Some firms are experiencing/generating significant increases in the demand for their legal services. Of course, if the overall market is flat, some firms have to be experiencing significant declines in the demand for their legal services to offset those strong performers. Within the data points in this chart, each "gainer" is offset by an approximately equal "decliner" and the net result is an average growth rate of 0.5%.

Of course, one year may not tell the whole story. It is possible that any firm moving up or down was simply reversing an aberration from the prior year, so we analyzed a two-year trend data. The results are consistent with the one-year analysis but with a m*ore* dramatic dispersal pattern (see the following chart):

Of the 119 firms represented on the chart above, only 48 actually had one up year and one down year between 2010 and 2012. Thirty-seven firms saw two "up" years in a row, with cumulative gains ranging from 2% to almost 40%. The remaining 34 firms (29%) had two consecutive "down" years, with cumulative declines ranging from 3% to almost 20% (see the following chart).



Hidden behind the initial, modest, overall 0.5% increase in the overall demand for legal services is the fact that "winners" and "losers" of business are rapidly developing in the marketplace, albeit with a group in the middle that is just hanging on (or drifting sideways?) At a minimum it seems fair to say that those firms seeing multiple, consecutive declines in their business base are losing market share. Absent corresponding strategic adjustments to address their over- supply of service capabilities, some of these firms are headed toward a crisis. They need to do something to turn these downward spirals around quickly.

General Characteristics of Winners and Losers of Market Share

While each law firm has a unique story, we have looked at the outlier segments of firms that are gaining and losing the most market share in order to try to understand the differences. All firms want to be in the winners' column and the winners want to expand their leads on their competitors. At a time when the very nature of competition is changing rapidly, we believe knowledge of the identifiable characteristics of these firms is an extraordinarily valuable resource for firm leaders. We see the following key differentiators between the winners and losers of market share.

> *(Please note that these observations are based on public data and our knowledge of the firms in these groupings – not on a survey or a formal body of research. In that sense, they are "anecdotal". However, we believe the patterns are consistent, and provide a reasonable understanding of common traits.)*

- <u>Primary area of focus for firm leadership, and partners generally</u> – Not surprisingly, the firms that are winning market share tend to be externally, strategically focused on the marketplace, existing and potential clients, and their competitors. Conversely, those who are losing market share tend to be internally focused on day-to-day minutia of their firms' operations and how to re-allocate a stagnant or declining profit pool. The individual partners at "winners" are far more focused on winning new clients than, for example, worrying about how the client origination credit will be recognized in the accounting system.

  When we look deeper into the winners' group to (try to) determine where they are on the path of strategic evolution (please click *here* to view our prior newsletter article on this topic), we generally see strategies that are at least focused on a narrow list of selected competitive capabilities, with most of these firms having some form of integrated strategy that includes a talent strategy and a service delivery strategy aligned with the chosen (or identified) competitive capabilities. These are the firms that have already taken a hard look at their work processes to seriously align the firm with their clients' needs. They can drive down the cost of services without sacrificing quality and improve profitability at the same time.

- <u>Time/Planning Horizon</u> – Given the aforementioned strategic/external focus of the winners and the internal/operational focus of the losers, it comes as no surprise that the winners tend to plan for years in advance while the losers plan in 365-day increments, if at all.

This is not to suggest that the winners develop long term plans and never change them. To the contrary, strategy development is an ongoing mindset and planning is an annual event. Such consistent attention to the firm's core strategic objectives is critical, given the current pace of change in the marketplace.

Firms that fall more toward the losers' end of the spectrum are more likely to be highly focused on making their annual budget and will sometimes take short-term actions (e.g., laying off associates instead of unproductive partners) that produce short-term gains and longer term pains. While definitive capacity management decisions are needed in any firm, the winners will more likely manage the issue affirmatively, while the losers tend to delay action until there is little choice, and then react clumsily.

- Adaptability – Given the aforementioned rapid pace of change, firms that can evolve quickly are at a significant advantage over those that cannot change quickly…if at all. Winners are adept at looking at work processes, figuring out where improvements can be made, and then acting. Losers tend to get stuck in debates about "how we have always done things" and the reasons to resist change – either as a general concept or at the detailed levels of a work process. Winners know how to spot the next opportunity and move resources in advance of the developing need, while losers tend to stick intensely with what has worked historically, regardless of changed external conditions.

Other Characteristics of Losers or Potential Losers of Market Share

While the above descriptions are a broad in nature, there are specific characteristics – beyond declining overall demand for legal services - that are shared, in various combinations, by the firms in our losers' segment. These include:

- Chronic overcapacity – relatively poor utilization (average billable hours per lawyer) levels over several years is indicative of the firm's inability to adjust their supply legal services (the timekeepers) with the demand for their services (billable hours).
- Human capital obsolescence – this poorly understood and often avoided phenomenon has crept into many firms trending toward the loser end of the spectrum. Human capital obsolescence means that some partners have lost the ability to perform at a client-recognized "valuable level", which drops their economic contribution to the firm below the generally accepted "ownership level." These partners tend to have trouble staying busy, particularly at the expected market billing rates for a partner in their respective disciplines. Realization tends to be weak on their time, and they are viewed as being "underproductive." While under-productivity is a symptom, rather than a description of the issue, this tends to both exacerbate the overcapacity issue and be confused with it. Having more work will not solve this problem and generating more work is extremely difficult in the current marketplace.
- "Not on my watch" leadership – related to the preceding points, a senior (by age) leadership team that has a short term planning horizon is often not interested in serious change and

evolution. If you're hearing this phrase, your leaders may have one foot out the door at a time when the firm needs highly proactive leadership.

- "No commodity work" – Most firms provide some services that are viewed *by clients* as commoditized and much of the leading edge thinking on process redesign and profitability improvement is related to "commodity" work. With a few rare exceptions, firms that claim they do no commoditized work are both a) not being realistic, and b) missing an opportunity to improve the process and profitability of this work type.
- A purely revenue-based Partner compensation system – while the misuse of profitability reports can hurt any partnership, failing to use profitability data in decision-making can have an equally negative effect. When two Partners generate the same revenue and get paid the same profit allocation while one Partner uses significantly more resources than the other, someone is likely to notice…probably the Partner who uses fewer resources and is more profitable for the firm!

Next Step for the Losers of Market Share

It is not necessary to permanently accept the characteristics of the "losers" category. Change is possible…but not easy. Typical steps include:

1. Getting the best choice of leaders in place;
2. Agreeing that "culture" will not be used as a barrier to progress;
3. Right-sizing the firm for the current client base (because most such firms are too large for their client bases right now) and managing capacity going forward;
4. Forging a commitment – to the greatest degree possible – among the core members of the partnership to stay together and (re)build the firm;
5. Building a new strategy around the "new" firm; and
6. Implementing the strategy as quickly as possible – time is of the essence.

Recovering from a downward spiral is difficult, and will require a) serious, focused leadership, b) a strong commitment by the firm's critical people, and c) a degree of sacrifice by all involved. If the fundamental elements are missing, not only is success unlikely, but one must ask the question, "why bother?"

Next Steps for Winners of Market Share

Advice for the winners is easy. Continue to innovate and remake how you provide legal services AND make money. You have already created a competitive gap between your firm and some of the competition. Expand that gap. The time required for competitors to change is valuable time that you can use to your advantage. Apply the principals of process improvement and project management to all matters…not just those that involve fixed fees. Develop a complete talent strategy that will position the firm to best compete for the right talent for years to come. Go on the offensive with successful fixed fee matters and inflict further competitive pressures on those firms that cannot respond. Convert standard work processes to technical solutions and "make money while you sleep". Cannibalize your own business when it allows you to distance yourself further from the competition. Finally, remain focused continuously on building and replenishing your core competitive strengths.

Conclusion

We recently spoke on the topic of "What your firm will look like in 2015". The goal was to illustrate how the changes referenced above will manifest themselves in all types of firms. We observed that some firms are going to look like empty offices…because that is what they will be (unless some new tenant has already absorbed their space). Many firms are poised to fail over the next few years. If they do, they will be the ultimate losers and their failures will be due to an inability to match the pace of change of the winners, who are reshaping the legal industry every day and taking their market share.

While our overall storyline is difficult to see at first, understanding its details is vitally important for long term success. And that, our friends, is the *rest* of the story.