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Financial Out-Performance

Over recent years the gap in profitability between the more financially successful firms and others has increased substantially. This is not only true of the market overall but equally for groups of peer firms competing in similar segments of the market.

Some may argue that the more profitable firms simply work longer hours and achieve higher rates and while this is often the case the critical question is how do they achieve this and what differentiates them from other firms?

Over recent years we have worked with a significant number of firms – both larger international and mid-sized and smaller national and regional ones - to help them improve their profitability. This work has included a substantial volume of analysis of individual firms, offices, practices and clients. Through this a number of findings have emerged – some more obvious, some perhaps less recognized – that start to provide greater insight explaining the differences in performance between firms and to the question of how some firms consistently outperform others.

Good and Bad Markets

The legal market is not homogeneous; it is made up of a number of distinct segments. The better markets, from a law firm profitability perspective, are those in which demand is relatively strong compared to the number of firms perceived capable of meeting that demand. Conversely, poor markets are where there are considered to be a large number of capable providers relative to the levels of demand and this situation can be exacerbated where the number of clients is relatively small and hence they have a stronger negotiating position. A particular example of this concerns what might be regarded as 'secondary work for primary clients' where competition can be particularly high and clients very demanding in terms of pricing. An example of a 'good' market, in contrast, is where clients require a single firm to provide services on the same matter in multiple locations – in which case there tend to be relatively fewer credible providers (competitors) for such work, and its perceived value is often higher, resulting in reduced pricing pressure.

Scale

While there are notable exceptions, small offices and practices tend to be less profitable than larger ones. Firms that comprise a relatively large number of smaller practices tend to be less profitable than firms that focus on a smaller number of areas of work and have fewer, relatively larger practices. This tends to repeat itself at the office level and small offices within a firm are often not as profitable as larger ones. (See also our Perspective 'Experience Curves' on the competitive advantages of scale). This raises interesting questions over the approach of 'investing small' in new areas and only investing further once the profitability is proven. It is possible that with such an approach the potential of a particular practice or office will never be proven and hence the underlying potential never realized.

Competitiveness

While the validity of the rankings in the various legal directories continues to be questioned by some, they are increasingly seen to provide a reasonably accurate indicator of the strength of firms and practices. Using these rankings as a measure of the relative capabilities of any firm or practice provides a means to determine the number of ‘superior competitors’. In firm after firm we have found that the lesser the number of ‘superior competitors’ to an office or practice the higher the relative profitability. The greater the number of ‘superior competitors’ the lower the relative profit. Put another way, higher ranked practices and offices tend to be more profitable than lower ranked ones – and this can be seen both between and within firms. Quite simply, more competitive practices as measured by their relative rankings tend to be more profitable than less competitive ones – they tend to attract more work, face less price competition and achieve higher realization.

Practice Mix

Certain work continues to be perceived as of greater value by clients and thus tends to command higher rates. Work that is of critical strategic, financial, competitive or reputational importance – what we term ‘crucial’ and most likely to be instructed from a more senior level within the client organization – tends to be more profitable. Exactly what this work is varies to some extent from client to client but tends to be high stakes. And our analysis indicates that the higher the proportion of such work any firm is undertaking the more profitable it tends to be. (One clear exception to this concerns low value, high volume work undertaken with an appropriate process driven and leveraged business model which can deliver very high levels of profitability).

Location

Firms that have a higher proportion of their lawyers in primary financial and legal centers tend to be more profitable than those that have a lower proportion. Taking publicly available data of firms over a number of years shows that for the majority of leading firms there is a very close relationship between the two. There is an obvious danger here of extrapolating in an over-simplistic way. Firms are not per se more profitable because of their location in a primary center (as evidenced by the large number of offices and firms in such locations that are not particularly profitable). Firms in such locations do, however, tend to be more profitable than firms in other locations so long as they have developed the capabilities required to be competitive (as previously identified).

Internal Management

Our analysis indicates three internal factors in particular that have a substantial impact on profitability. First, more profitable firms tend to be more effective at managing the shape of their staff pyramid and recognize the adverse impact of having too many too senior (and hence too expensive) lawyers doing work that should be undertaken by more junior and less expensive staff. Second, more profitable firms tend to be better at managing the ‘tail’ of less profitable work they undertake – either by not continuing to undertake it or by finding lower cost approaches to doing so. And thirdly, more profitable firms do tend to work harder than less profitable ones. They win more work because they are more competitive and then they achieve greater productivity because culturally they expect and achieve higher performance from staff.

At this stage there are no irrefutable conclusions – we continue to come across situations that are at odds with the broader findings and we also recognize that there are other factors at play whose impact we have not yet been able to quantify.

Unsurprisingly our analysis confirms the accepted wisdom that more profitable firms tend to work harder and also tend to achieve higher rates. But it is the factors that enable them to achieve this that are in our view of greater interest and importance. And while some of these factors are not readily manageable, others most certainly are. By focusing on these factors our experience is that substantial and sustainable improvements in profitability can be achieved.

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