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INSIGHTS

Scale Counts

Because legal markets around the world differ so markedly - in terms of scale, levels of competition, profitability, rates of growth, degrees of segmentation, regulation, and so on - it is right to be cautious in drawing conclusions from one jurisdiction and applying them to others. On the other hand, being aware of what has happened in other markets, and in particular those that are at an advanced level of development and competitiveness, can provide useful indicators and guidance. The UK is just such a market. And while the UK is distinctive in some important respects there are important trends in the market at least some of which will likely be reflected in other jurisdictions.

The UK legal market is characterized by a number of features that have contributed to its relatively advanced stage of development:

- it is highly competitive
- it is particularly concentrated geographically (in London)
- clients are among the most sophisticated in their purchasing, highly demanding and for much work intensely price conscious
- reflecting London's strength in banking, financial and professional services related legal services represent significant practices for many larger firms
- the perceived attractiveness of the legal system attracts work – both contentious and non-contentious – to the UK
- recent regulatory changes mean legal services can be provided by organizations other than traditional partnerships and also outside equity investment in law firms is allowed - contributing to both new competitors and new types of competition in the market

In 2008 we undertook an in-depth analysis of the UK legal market. Recently, we repeated and updated this analysis, considering how the market has developed and how it is likely to continue to develop. A number of conclusions emerge from our review including important insights into the more and less successful strategies that firms have pursued.

One of the particularly notable outcomes of this analysis concerns scale and the relative out-performance of the largest firms.

- In aggregate the largest 15 firms have grown at twice the rate of the remainder of the Top 100. 15 years ago the largest 15 firms and the next 85 were equal in terms of revenue; today, the largest 15 firms have aggregate revenue double that of the next 85. And since 2008 the largest 15 firms (certainly aided by some significant international mergers) have grown at double the rate of the other Top 100 firms.
- While profit margins overall remain below the peak achieved in the period just before the global economic crisis the largest 15 firms are on average achieving higher margins currently than a decade ago while the next 85 firms are achieving lower margins. Importantly the largest 15 firms have improved their margins from the slump of 2008 while the others have not.
- The average profit per equity partner of the largest 15 firms was double that of the next 85 in 1998. In percentage terms that difference has widened a little although in monetary terms, because the profitability of all firms is higher, the difference has increased very significantly and this, combined with their greater scale, leads to a markedly different potential to invest between the two groups of firms.
- Over the past decade the largest firms have reduced their leverage. In contrast the other 85 firms have increased their leverage and are currently operating at about 20% above the largest 15 firms. This leads to two important conclusions: first, that the stronger performance of the largest firms in terms of profit per equity partner is not a consequence of 'financial engineering' (i.e. significant de-equitization) and second, that contrary to conventional

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wisdom recruits to the largest firms may have better prospects of becoming equity partners than their peers in the next tier of firms.

These largest 15 firms are by no means homogeneous – their strategies are markedly different. Some are relatively full service, others particularly focused on certain sectors or practices; some are highly international, others largely domestic; some are transactions and finance focused, others have strengths in other practices; and some focus on the very highest value work while others have more of a mid-market focus. Their relative success therefore is not due to them all following similar strategies. And interestingly the firms that constitute the largest 15 have changed very little – 14 of the Top 15 today were Top 15 a decade ago.

What can we draw from this? It would be erroneous to conclude that scale automatically leads to success and it is important to recognize that some of these large firms have been considerably more successful in growing their revenue than their profit or margin. On the other hand, it would be equally wrong to conclude that these firms have not used their scale to their advantage – in terms of the way they have managed their expansion, marketed themselves to clients and, perhaps most significantly, managed themselves internally. And while all these firms have 'star' partners their success is significantly derived from the powerful underlying brands they have built.

Being larger is not a panacea or an automatic safe haven from the pressures of the market. And the market trends identified may not continue. On the other hand, the evidence from the UK is that the largest firms (along with those firms with a very clearly focused strategy - which we will write about in a separate Insight later in the year) are among the most successful. For the majority accompanying their scale is a clear direction of development and high level of discipline to both their operational and strategic management.

Our analysis indicates that the largest UK firms have effectively used their scale in increasing their competitiveness. Other firms, both within the UK and elsewhere, operating in increasingly competitive markets, should take note of this and recognize the need to develop and implement equally effective strategies to counter the potential advantages of scale and to protect their own position from larger firms.

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