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Strategic Management Consultants

THE LEGAL MARKETPLACE IN LATE 2009 – WHAT LAW FIRM LEADERS ARE SAYING NOW

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2009 has been a watershed year for the legal marketplace. Law firms have suffered through a year of severe economic dislocation, there have been greater attorney and staff cutbacks than at any time in history, and, perhaps most importantly, the perception of many partners (both young and old) that the gravy train of unchecked profit growth would continue unabated was severely dashed. But, while many firms and practices have taken severe hits, most have not, and the law firm diversification model has proven itself to be remarkably resilient – particularly for mid-sized law firms. As one looks back at the carnage, with few exceptions, law firms have fared considerably better than their clients.

Smock◆Sterling has placed considerable emphasis and effort this year on staying abreast of legal marketplace developments. We have authored a number of monographs, based on solid research (not conjecture or bias), and spoken/presented to client firms, law firm groups, and other professional organizations. Our message has been consistent and guardedly optimistic – focus on your clients' needs, get out in the marketplace (stop hunkering down), and, at the end of the day, you will find that results produced will be acceptable and, in many ways, surprisingly positive.

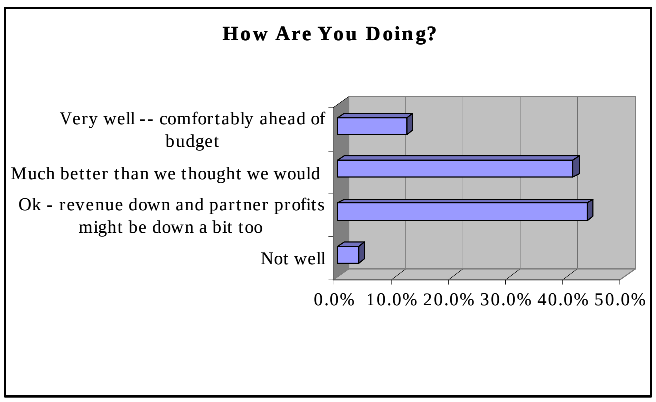
As part of that continuing attention to the marketplace, we recently conducted a brief anonymous web-based survey on the present and future legal marketplace. Nearly 100 mid-sized law firms responded (note: only two-percent of responses were from firms larger than 300 attorneys) which provided us with solid and valuable information. This monograph summarizes the results of that survey, points out some lessons learned from recent experience, and winds up with some suggestions for 2010, as readers plan and budget for 2010.

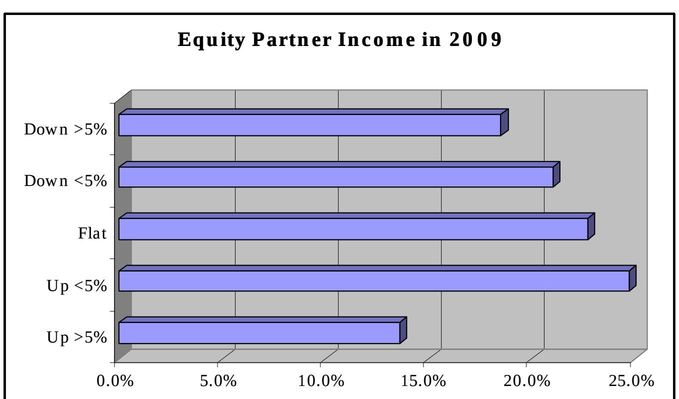
SUMMARY OF THE SURVEY – THE PRESENT AND FUTURE LEGAL MARKETPLACE

We asked 26 questions on the present and future legal marketplace. We have aggregated and summarized the responses in the following.

How Are You Doing in 2009?

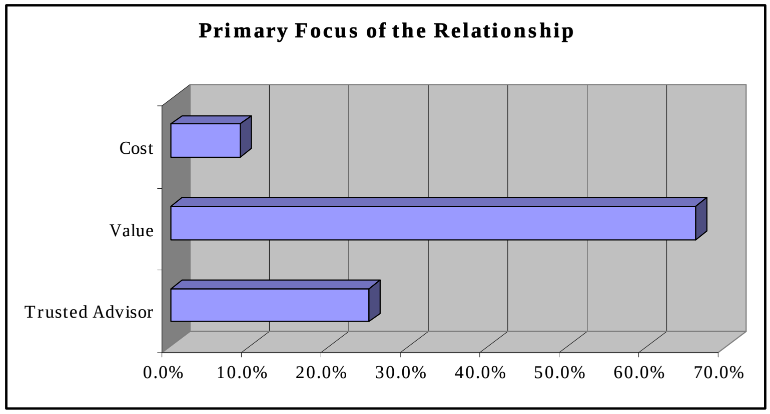
We opened the survey with a general question – **how are you doing**? The responses were more positive than we expected – only 4% said they were not doing well, 43% said they were doing ok (though down a bit), and 53% said they doing much better than they thought (41%) or very well (12%). These results are nowhere near the gloom and doom prognosticators (some of whom are our competitors) who held sway (much to our chagrin) in early 2009.





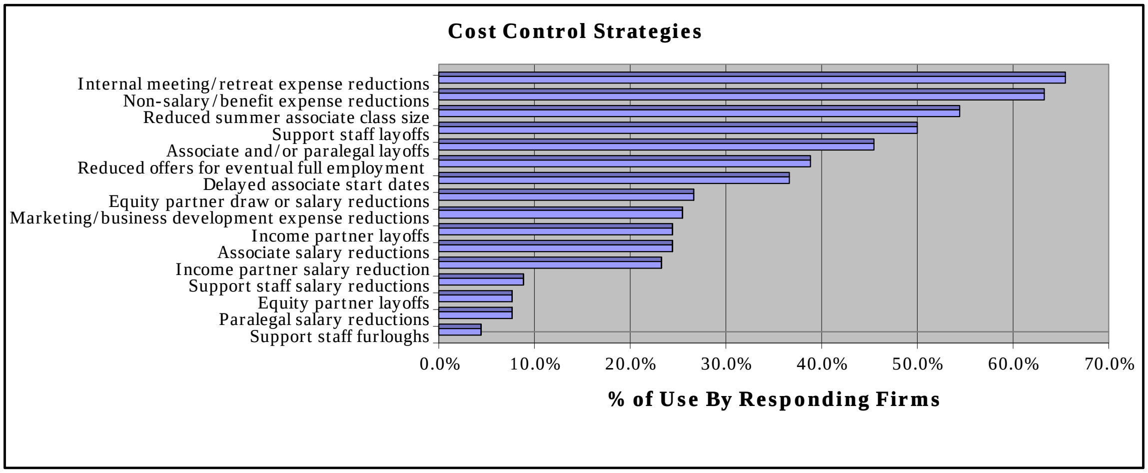
We also asked **what will happen to partner profits in 2009** and again received considerably more positive responses than we might have presumed given the prevailing media buzz. The interesting and very significant response here is that only 39.5% see average profits per equity partner going down (the majority of that down less than 5%). And, 60.5% will be flat or up – a remarkable result, considering what has happened and the panic that ensued. In fact, for a firm to be down more than 5% appears to be a function of practice mix (i.e. – a greater percentage of the practices that have been hit hard) and/or management issues.

We also asked about **clients' primary focus in their business relationships with outside counsel**. There were three choices – cost, value, and trusted advisor. Our initial presumption was that clients would have a *"laser-like focus on costs"* – not so, the focus on value (results ÷ cost) represents a significant majority. The conclusion must be that cost is important (and probably more so than it has ever been), but so are results (and quality). Cheap, mediocre lawyers are not taking over the market.

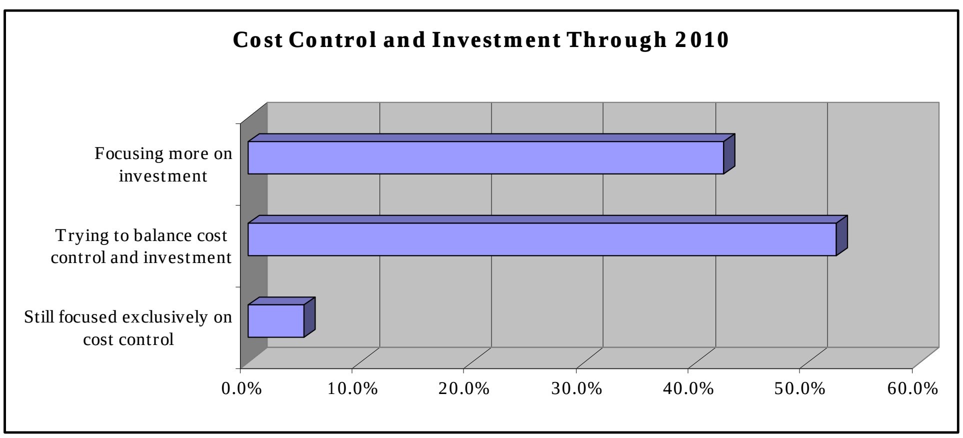


What Steps Did You Take to Cut Costs?

As has been extensively discussed, virtually all law firms focused on their cost structure this year – even if they did not have any layoffs. We asked **what they did to cut costs** and the responses are shown in order of magnitude. Interestingly, the higher utilized strategies appear to be the least painful (for equity partners) – those generally are the things that can be done first without expending internal political capital.



Obviously a good number of firms used multiple cost reduction strategies.



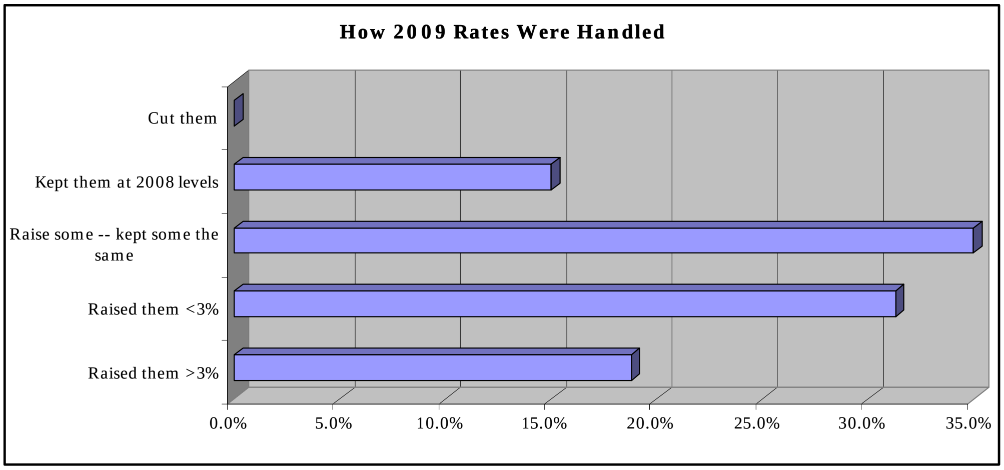
We then asked how **the responding firms will be balancing costs and investments for the rest of 2009 and 2010.** It is important to note that respondents were firm CEOs and Executive Directors/COOs and these individuals tend to be more investment oriented – however, we suspect that many of the partners in responding firms are still hunkered down and remain resistant to spending money on anything that is not essential.

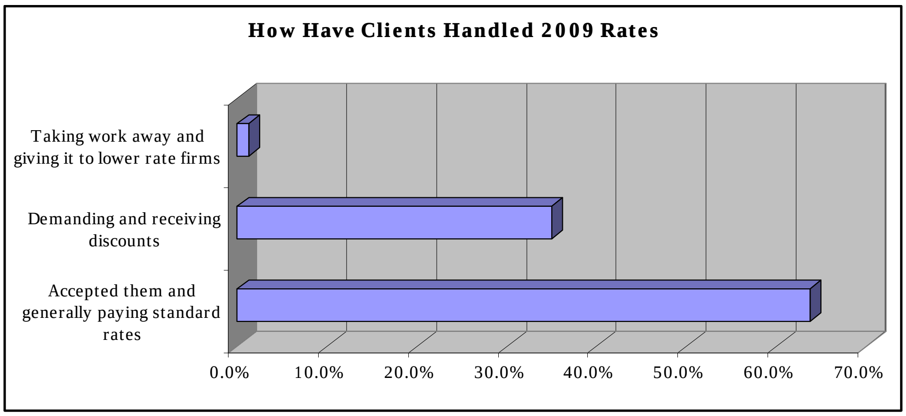
Increase in Accounts Receivable

A key element of firm performance has been the assertion that clients have **slowed their payment of outstanding invoices**. The responses confirm this – 58% experienced either a significant increase in days in accounts receivable (greater than 10%) or a very significant increase (greater than 25%). Only 4.2% experienced *"not very much"* increase in collection delays.

Billing Rates

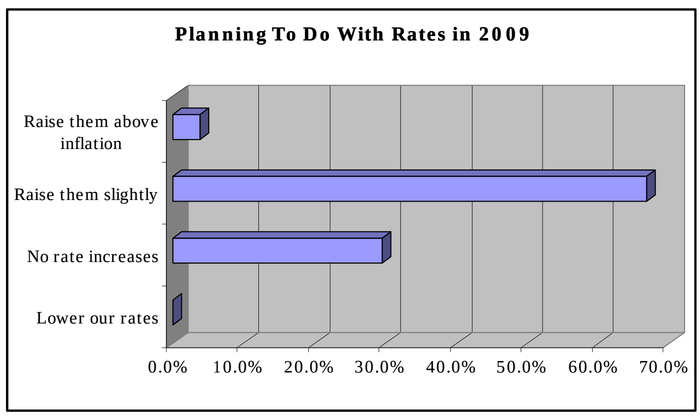
We asked three questions on rates. The first was **how firms handled rates in 2009.** Only 15% kept them at the 2008 levels, no respondent cut them, and a combined 85% raised rates – either some rates (but not across the board), raised all rates less than 3%, or raised all of them more than 3%.

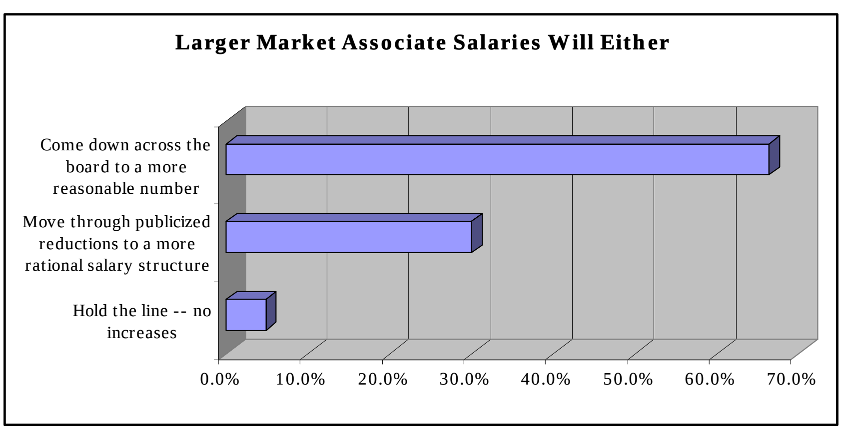




We also asked **how clients responded to firms' 2009 rates** – and the answers were again, somewhat surprising. The conventional wisdom is that clients are – across the board – resisting rate increases. Given our sample, that is not what has happened. Generally the 2009 rate increases have stuck – with discounting being the preferred tactic for responding to client push back on rates.

Finally, we asked **what firms are planning to do with rack rate increases in 2010**. Over 70% of the responding firm s intend to raise them (the overwhelming number planning to raise rates *"only slightly"* – about the rate of inflation), but only a small proportion (only 3.8% of the total responses) intend to raise them above the rate of inflation.

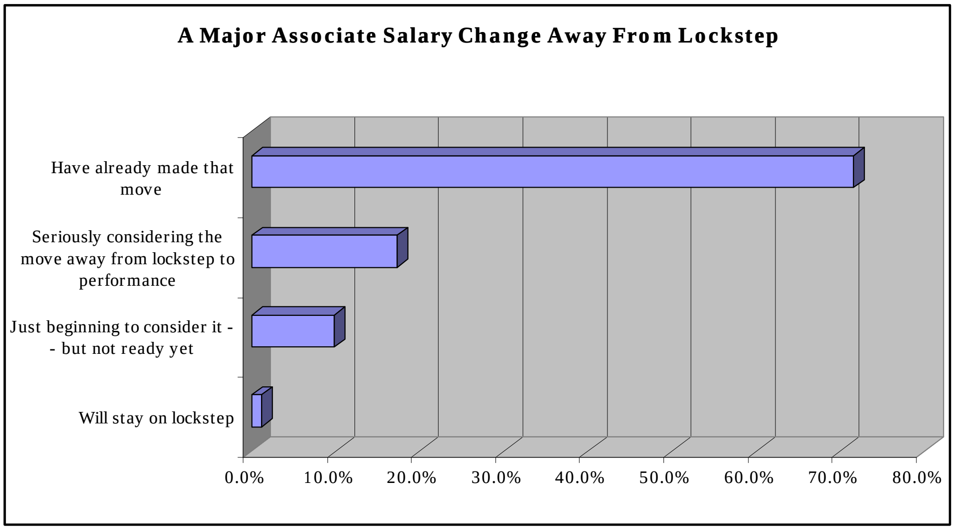


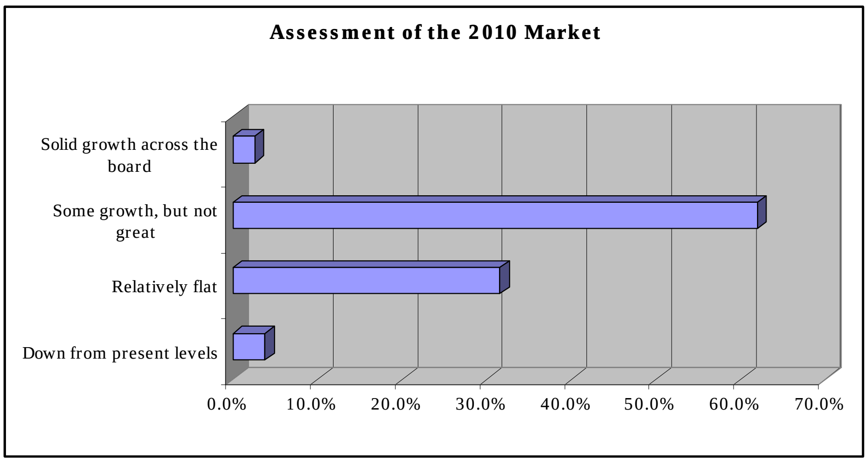


Associate Salaries

We asked the respondents **what would happen to associate salaries in the larger markets** (which fed the increases in all markets). The great majority (90% or so) feel that larger market associate salaries will either come down or come down in conjunction with salary structure revisions. If this happens, it will more than likely lead to major associate salary changes across the legal marketplace.

We then asked whether this **economic environment will cause a major change in the associate salary structure** – primarily away from lockstep. We were surprised and generally encouraged by the number of firms who have begun tackling this critical strategic issue.





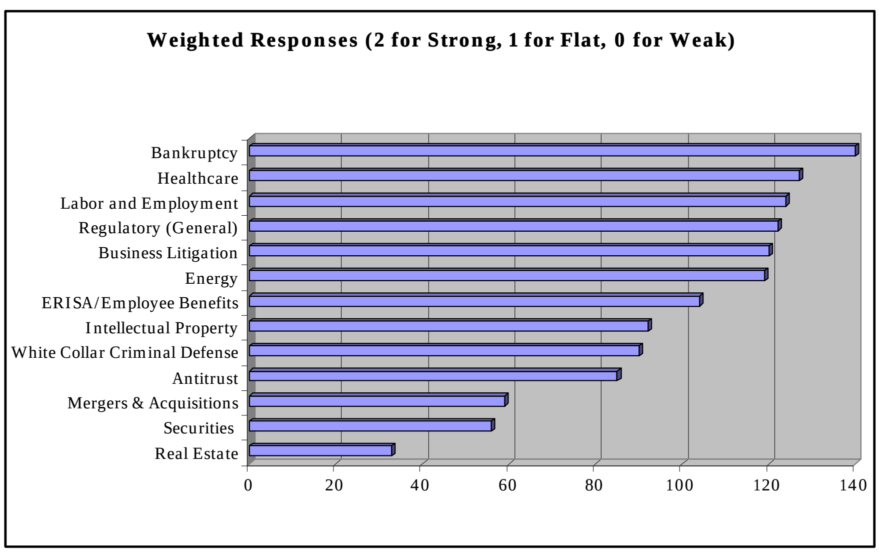
Assessment of the 2010 Legal Marketplace

We asked how the respondents viewed potential/probable 2010 firm performance (revenue and profitability) in the context of the broader legal marketplace. As with the present market, the responses were more optimistic than we anticipated they would be. Fully 65% expect growth (either "*solid*" or "*some*"), 32% expect a flat year, and 4% expect it to be down.

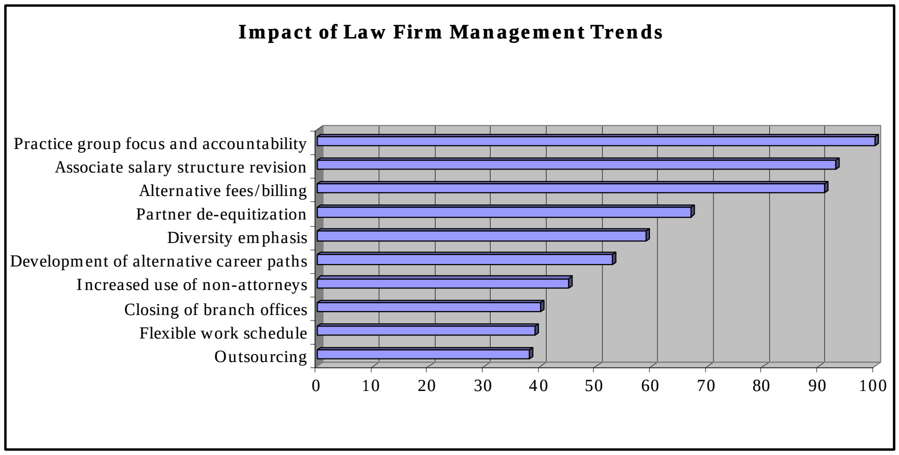
What Practices Will Be Hot – And Not?

We then asked about the **future prospects of a variety of practices for 2010 and 2011.** There were three potential responses (strong, flat, or weak). We scored these responses (2 points for strong, 1 for flat, and 0 for weak). The weighted results depicted here in the order of that scoring.

Not surprisingly, bankruptcy leads the list – with healthcare, labor and employment, business litigation, and energy following. Real estate, not surprisingly, received the weakest score, followed by securities and M&A.



Impact of Trends in the Legal Marketplace



We also asked about the **future impact of trends in the legal marketplace.** We cited a series of trends that have been discussed in the legal management media; asked whether these trends would have significant, some, or no impact; and scored the responses (2 for significant impact, 1 for some impact, and 0 for no impact). The scoring by trend is captured in the graph.

Apparently, there is a belief that "*hard*" management trends (i.e. – practice group focus and accountability, associate salary restructuring, and alternative fees/billing) are considered to be of considerably more significance than what might be considered trends in "*softer*" management areas (e.g., human resource oriented trends).

LESSONS LEARNED

Based on the results of the survey, as well as our continuing meetings with law firm leaders (both firms we have served and others we have not served), we believe there are some key lessons that can be learned from the past year of economic issues.

The Resiliency of the Economically Diverse Law Firm Business Model

While it has been difficult, the law firm business model of providing a diverse set of skills, services, and products – needed at different times in the business cycle by clients – not only meets those client needs, but provides a remarkable resiliency in difficult economic times. We have always felt throughout this economic dislocation, that law firms were doing fine (particularly in comparison to most of their clients), but the level of positive feedback from the survey respondents surprised us a bit. It showed us that our relative optimism (and encouragement to our clients) was not only appropriate but understated.

The lesson is straightforward. Diversity of practices is wise strategy to ensure continued viability and ultimate success in even the most difficult of economic times.

It Is Still Very Tough Out There

The responses to our survey were more optimistic than we expected – but, we should not have been that surprised. The comments we hear from law firm managers – in the course of consulting assignments, marketing calls, or simply marketplace discussions – have also been guardedly optimistic. Firm leaders feel the worst is over and the damage has not been nearly as bad as it could have been.

But, everyone recognizes that it is still very tough out there – 2010 is not expected to be a barn burner.

- The transactions market has not come back. Yes, deals are picking up, but until credit loosens and banks start providing capital, the deals will be done by those who already have the cash.

- Real estate has not shown any significant sign of turning around – there is a belief that 2010 will be very tough year and the *Wall Street Journal* reports that 55% of commercial real estate loans due before 2014 are currently underwater.

- An interesting comment was made to us by a good client – "*we may be busy, but clients both do not like spending the money and, importantly, are not happy with what they are spending it on.*" In other words, they would rather use legal assistance to make a positive acquisition than to defend a reduction-in-force.

- What had become a competitive environment is now even more competitive – requests for proposal, convergence, and alternative fees (to name a few) are increasing that level of competitiveness. Also, as compared to a few years ago, there is not enough work to fill present capacity – even after layoffs. There are many attorneys quite desperate for work.

Frankly, It Could Not Have Gone On Forever

Just as real estate had a bubble, so did business law firms. There were seven years of plenty – seven consecutive years with rate increases averaging greater than seven percent – that led to enormous profitability increases. These rate increases could not be sustained competitively and the reaction by clients, while slow in coming, was unavoidable and justified. And, while there will not be seven years of famine, the bubble of plenty has burst.

There is no question that clients are now more focused on value than they have ever been. Outside counsel costs have become a "*material*" item to overall company management and, whether clients like it or not (and they do not), they will remain a material item. The value performance bar has been raised and will stay high. Law firms have to perform or will be replaced and that will more than likely happen with greater frequency than in times past.

Law Firms Are Subject to the Same Economic Rules as Other Businesses

The experience of large and small firms in this economic downturn has been instructive – basic economic principles could not be avoided. While many firms were able to avoid layoffs (real or stealth), most were not. If you have too much capacity and the business that used to absorb that capacity does not shortly return, you have to adjust your capacity to the present and expected work. Further, if career opportunities (e.g. – with other firms, with industry, etc.) are not available, attorneys and staff will not jump ship. As a result, attrition has been dramatically reduced which, of course, reduces the need to hire.

There Were Cost Savings to Be Had and Law Firms Took Advantage

Beginning in the summer and fall of 2008, virtually every law firm looked very closely at the expense side of its ledger. They found significant opportunities to save expenses and moved quickly and convincingly to deal with those opportunities. And, those cost savings had a significant positive impact on firms' results – particularly when coupled with the very conservative budgeting that was being done for 2009. But:

- Some of these cost savings were only temporary. You cannot postpone marketing expenses and business meeting travel forever. You do have to spend money to make money. Prudent investments in these (and related) categories are necessary to function.

- You cannot take it all out of the hide of associates, income partners, and staff (see the survey results). Ultimately, high standards of performance must be upheld and enforced for equity partners. In fact, those firms that effectively dealt with the underproductive partner issue in 2007 and 2008 experienced a substantial positive financial impact in the tough times of 2009 – in a few cases, a significant profit windfall.

- And, cost savings will not have the impact in 2010 and 2011 that they did in 2009 – the easiest cuts have already been made.

Quality and Value Trumped (and Still Are Trumping) Size

In a monograph we wrote about six months ago, we talked about the emerging and strong competitive position of the "*high quality/competitive rate*" firm – primarily high quality mid-sized firms. That phenomenon has continued unabated. Firms that are able to demonstrate high quality and value (and that often means – as a starter – lower rates than major city firms) have been able to take work away from much larger and, in most cases, more expensive firms.

The media has picked up on this and viewed it as a geographic phenomenon (e.g. – the rise of Midwestern firms). They are wrong. It is quality and value that are of importance – not location.

By the way, we do expect that most of the larger high quality money center/major city firms – many of whom have been hit very hard by this economic upheaval will figure out a formula to deliver that quality and value balance and will return to a position of competitive strength. But, the high quality/competitive rate firm is here to stay.

The Importance of the "*Soft*" Stuff – An Agreed Upon Strategy, Culture, and Internal Values

While most firms benefited from a combination of conservative budgeting and enhanced cost control in 2009, they also were well served by the existence of an agreed upon strategy. Having an clear strategy enabled these firms to keep an "*eye on the future*" and to tell their partners that there was a real light at the end of the tunnel.

- Another question we asked in the survey was how the firm was doing relative an overall strategy in these difficult times. Encouragingly, 66.7% said that "*we have a good plan and are still focused on it and are committed to it.*"

- Also, the importance of culture and values was underscored, particularly as many firms were cutting back personnel. We believe those firms that had mutually respectful but businesslike cultures were better able to carry out these necessary and tough changes.

WHAT DO TO (ABOUT THIS) IN 2010

As with all of our monographs, the following are Smock◆Sterling's recommendations for firms to build on the information presented in above and to deal with the challenges of 2010 and beyond.

Get Out of the Foxhole – the Artillery Barrage Is Over

We believe most law firm managers believe that their firms have survived a significant scare and are now poised to focus more directly on achieving success (as defined strategically for 2010 and beyond).

- But, many of their partners are still hunkered down – fighting any and all expenses and, in some cases, surviving on a day-by-day basis to remain busy and productive.

- Partners demanding everyone continue to hunker down are wrong. The analogy that the artillery barrage is over and it is time to get out of the foxhole is apt. Management cannot and should not be constrained by those hunkering down. The truth is if those hunkering down have a veto over doing the right thing, the firm will not survive in a very competitive 2010 and beyond.

- Now is the time for firms to move forward on their strategies (quality, growth, whatever) without being impeded by internal fear.

Remain Financially Prudent – And Raise Rates (Modestly and Carefully)

Value will remain the primary client objective and costs are a key component of the value equation (value = results ÷ costs). So, firms need to be very sensitive to what they charge, how they charge, and for what. With that caveat, we recommend that firms raise their rates in 2010 – not much, but enough (possibly at or near the rate of inflation). If you do not, you run the risk of falling behind the competitive market.

Address the Associate Compensation Issues with Leverage

While a large number of law firms have cut associate salaries, many have not (*"we're waiting to see what our competition is doing"*). We recommend firms address this issue directly.

- We recommend revising and adjusting the structure before *"cutting salaries."* Simply put, move away from the lockstep model to a performance model that enables high performers to make more than they would have under the lockstep model (and, obviously, mediocre and low performers to make a good deal less).

- The next step is to then implement that structure – which will not only reduce costs, but incentivize the best people to continue to perform.

Emphasize Those Key Things That We Have Previously Recommended

We recognize that some of our recommendations can be repetitive from monograph to monograph. However, we see that as a good thing, as it has been our experience that some strategies consistently have a positive impact on a firm's bottom line and ultimate market position. Thus, we suggest – again – that:

- Firms ensure that their strategy is relevant to the marketplace and aligned with client needs and that **everyone** in the firm understand what the firm is trying to achieve – and participate in that achievement.

- Firms formally follow-up – in a face-to-face manner – with clients (start a formal program if you do not have one and expand what you are doing if you do). Simply put, get the partners out of the office and with clients more often. Find out what your clients are doing, how you are doing in their eyes, and what motivates them. The end result is invariably an increase in the volume and sophistication of the work you do for those clients.

- Emphasize truly effective practice group management – requiring accountability from practice group leaders, but clearly giving them the support and resources necessary to carry out their jobs.

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Smock◆Sterling Strategic Management Consultants is a strategic management consulting firm with broad experience in serving the nation's leading law firms. Founded in 1991, we have grown our reputation and client list to become one of the leaders in providing high quality, high value strategic management services to the legal profession in five areas (strategic planning, mergers and combinations, practice group management, law firm economics, and strategic management issue resolution). Although 75% of our work is for law firms, the remaining 25% is for top management in a variety of industries, which keeps us grounded in the thought processes and trends of the broader business marketplace – something none of our primary competitors do. Our three partners (the authors of this monograph) are, unquestionably, the most experienced *"first string"* of any consulting firm serving the legal profession.

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