

# How Healthy is Your Strategy?

by Patrick J. McKenna

“Let the champagne flow! Double-digit growth is back. The best year ever.” This was the common refrain from among managing partners in reviewing the results of their firm’s growth for 1996.

How is it then, that three years later, from Wall Street to Main Street, a thorough analysis of the latest Am Law 100 and the Am Law 200 numbers clearly indicates that significant brand-name law firms are operating with strategies that are quickly losing steam? In spite of the greatest economic boom in history, too many firms as of late, have experienced flat or no growth, and are in grave danger of having the stuffing kicked out of them . . . especially as the economy begins to slow.

In June 1989, one of the more astute observers of the profession, Steven Brill (then Editor-In-Chief of American Lawyer), in his bold prediction entitled The Law Business In The Year 2000, presented his list of the frontrunners for the “Top Twenty”. According to Brill at that time, “The Top Twenty Firms will be those firms that have a large enough critical mass to stock well-staffed teams of specialists in most cutting-edge practice areas; are located in at least five major cities in the United States and abroad, and most important, are leaders in revenue per lawyer.”

Fast forward to the year 2000. We find that three of the top revenue performers that now top the list weren’t even on Steven Brill’s radar screen, while a good number of the brand-name firms that were included are currently suffering flat growth and strategic inertia.

## Let’s look at the evidence.

With each new Am Law survey, firm management and partners alike immediately turn to the listings of profits-per-partner as the primary metric to determine how they are doing relative to competitors.

For firms, the profits-per-partner metric has often determined who is likely to be the best merger candidate, and (recently) provide the justification to either de-equitize partners or adjust the reporting of who are really equity partners in an effort to make the numbers look better. For some disgruntled star performer, the metric may determine which firm might prove to provide a greener pasture.

Profits-per-partner is a critically important metric, but let’s remind ourselves of how that measure is configured. We’ll start with a simple, straightforward formula best articulated by our colleague David Maister.

At the end of the year, you can divide profit-per-partner into four factors. Profit per Partner = Profit to Fees, which is usually called the margin, how much of our fees do we manage to bring down to the bottom line.

We multiply that by Fees to Hours, which is an implied rate. Notice it doesn't say anything about how you actually bill. It doesn't infer or imply that you bill by the hour, it could be fixed fees, it could be contingency fees, it could be anything. It's just total fees divided by total hours. What is the implied net collective rate that you are getting from your market place?

Then we move on to Hours to People. And that's a familiar measure for most professional firms, that's called variously chargeability, billability, utilization, billable hours, and any number of other terms. It's the amount of production per professional.

And then finally, the last thing to make our high school algebra work, is people to partners. If you look across all four of these ratios you see that most professional firms are a nice simple business.

#### THE BASIC PROFITABILITY ELEMENTS:

$$\begin{array}{l}
 \frac{\text{PROFITS}}{\text{PARTNERS}} = \frac{\text{PROFITS}}{\text{FEES}} \times \frac{\text{FEES}}{\text{HOURS}} \times \frac{\text{HOURS}}{\text{PEOPLE}} \times \frac{\text{PEOPLE}}{\text{PARTNERS}} \\
 \text{PPP} = \text{MARGIN} \times \text{RATE} \times \text{UTILIZATION} \times \text{LEVERAGE}
 \end{array}$$

Now let's look at what has been happening within the profession over the past 10 years, from 1990 to the last Am Law statistics reported for 1999.

- **Margin.**

Curiously, in the area of law firm margins, the numbers have remained constant to a decimal point. The average margin in 1990 for the Am Law 100 was 36.5% and it remains the same in 1999. (Unfortunately, there are no comparable numbers for the Am Law 200).

We could speculate on why these numbers have not changed over the past 10 years. One might have thought that given most firm's obsession with cost containment in 1990, a year when doom and gloom prevailed, the margin numbers in that year should have been higher, but that would just be speculation.

When we do examine only the top 20 firms we see an average margin of 39.85% in 1990 improving to 45.45% in 1999. What that suggests is that the top 20 firms may have a far easier time absorbing the costs associated to the continuing escalation in associate

salaries. And we do know that the higher associate salaries will not show up until next year and can be expected to impact margins in those of the top 200 firms that have succumbed to dramatically raising associate salaries.

Read all of this to mean an increasing pressure on profit margins.

### • Rates and Utilization

We need to combine rates and utilization to accurately reflect the Am Law numbers reported as revenue-per-lawyer (RPL).

The best measure of the health of a firm in terms of the demand for its services is RPL, which is a reflection of those firms that are doing premium, top-of-the-line legal work, in whichever marketplaces they happen to be practicing. RPL is a reflection of what rates lawyers are able to command in the marketplace for the value of the services they provide and is an indication of whether lawyers are able to enhance their personal value to clients such that clients are willing to pay higher fees. It is also indicative of how hard firms have been working.

Throughout the 80's firms could count on an ever-increasing RPL by steadily ratcheting up their billable rates and by charging hefty deal premiums. Revenues per lawyer at midsize and large firms doubled over the period of 1980 to 1990. Deal premiums began drying up in 1990 for a few years while at that same time, clients began to become far more sensitive to billing rate increases. That largely explained why a review of the 1990 Am Law 100 found that more than 25% of the firms saw their RPL remaining flat or declining. During the early 1990's firm sought to protect their RPL's by laying off associates and ratcheting up expectations of billable production.

When we dig deep and examine the RPL of the 79 law firms that managed to maintain a position on the Am Law 100 for the past 10 years, we find that the average firm evidenced an increase of 43% growth in RPL over that period.

43% growth in revenues per lawyer doesn't sound too bad – but it does tell us that the overall growth from 1990 to 1999 was less than half the growth for the 10-year period from 1980 to 1989. And it does clearly indicate that the profession is firmly in a “mature” phase of its growth, and that growth in much the same way as the smokestack industries experienced, has begun to “top out”. It further portends a future where firms can expect to experience even slower growth in fee revenues, diminished profitability per lawyer and declines in margins.

It also doesn't tell us for sure whether this 43% growth came from increasing rates or increasing utilization – and it makes no adjustment for inflation over the past 10 year period. Again, we could make an assumption, based entirely on observation and a gut-feel, that a majority of this growth really came from an increased emphasis in billable production; not from any increase in rates or implied value to clients. But that would only be an assumption.

What is fact is that an even closer look shows that 48 of those 79 firms couldn't achieve the average growth of 43%, (11 firms actually fell below half the average). A further 12 firms while displaying stellar results from 1990 to 1996, now show absolutely flat or decreased RPL numbers over the past three years – during the height of one of the greatest economic booms.

The remaining 19 star performers present an interesting picture. They are based across a wide geographic spectrum (not just concentrated in New York), serving not necessarily just new economy or old economy clients, not necessarily the largest firms in their markets, and not necessarily global in their office configurations. Clearly, these firms are doing something very different from the others.

When we then look at the Am Law 200 we see an 8% growth rate in RPL over the past two years, the only years for which the Am Law 200 data has been available. 68 of the 93 firms (73%) that remained constant on the list for those two years did not achieve average RPL growth. Perhaps most alarming, of those 68 firms, 22 firms could not grow their RPL. Another 8 firms experienced flat growth and a further 14 firms actually had declining RPLs.

Clearly, what these numbers tell us, is that the underpinning to most of the so-called strategies that firms employed throughout the 1990s was an internally-focused, work harder, firm mantra. And it worked to this point in time. We have now witnessed a prolonged period where so many firms had done so well on paper, for so long, for no good reason other than to work harder.

By 1997, lawyers at America's highest grossing firms were struggling to cope with an ever-increasing killer workload. And today, attorneys are working more than they ever did, even in the boom years of the mid-1980's. Only one small problem, as hinted at in the July 2000 issue of American Lawyer – we are now “hitting the wall!”

What happens when lawyers can't work anymore hours? What happens when you reach the ceiling of human endurance? In short, it takes no genius to foresee that sooner or later you reach a point where no further growth can be achieved simply through pushing the utilization envelope.

- **Leverage.**

The last of our four factors is leverage. Again it is an interesting observation to note that leverage has barely increased as an average for the Am Law 100 over the past 10 years. The average leverage for firms in 1990 was 3.20 and in 1999 was 3.55. (Unfortunately again, there are no comparable numbers for the Am Law 200).

When we look at leverage among only the top 10 firms, we see a far healthier leverage of 4.13 in 1990, but see that it has actually dropped slightly to 4.11 over the ten years ending in 1999.

## WHAT DOES ALL THIS MEAN FOR THE FUTURE?

As a conscientious managing partner, you could begin to focus some attention on improving your firm's margins. Small problem. Beyond the escalating associate salaries you have to deal with, there remains the continuing need to invest in new technology, computer upgrades, renew leases, finance new office expansion, and pay for that expensive branding initiative your firm committed to. A little, but not much wiggle room here.

Having already examined utilization, we see that the strategy of simply working harder may have allowed many firms to make measurable gains during the last decade, but it is nearing its logical peak. This isn't going to be the driving strategy for the future.

That leaves us only with either raising rates or improving leverage. In fact, the whole issue of rates and leverage is being re-addressed already by some radical competitors who have found new ways to provide frontier services, exchange services for equity, deliver offerings by way of the internet, and repackage their services in a more tangible way that favorably distorts the way we have traditionally measured leverage.

Technology is transforming the way legal services are provided. Technology will so greatly speed production and reduce reliance on people that firms will soon be unable to measure the value of their services by the time they spend delivering them. Instead, they will be forced to look at the clients' perception of the results achieved, the product delivered, and the relationship itself.

All of this is going to demand new and radical strategies, vastly different from those that have evolved from conventional planning efforts of the past. And let's face it, what have those firms that have engaged in the same old strategic planning exercises with the same old consultants, accomplished thus far by way of wealth creation and profit enhancement?

Consider:

1. Does your current strategic plan provide for innovative new ways to improve your firm's leverage or raise billable rates, or does it really just propose doing more of the same?
2. What does your current strategic plan have you doing that challenges the status quo?

Challenging the status quo has to be the starting point for anything that goes under the label of strategy.

3. How different is what you are doing right now – the strategies that you are employing now – from the four or five largest competitors in your marketplace?

If you answered “not much” then how are you ever expecting to surpass their performance?

Strategy is about setting yourself apart from the competition. It’s not just a matter of being better at what you do – it’s a matter of being different at what you do.

RSM McGladrey is one of the major national accounting firms in the U.S. According to some of their recent research, there’s not much difference among most of the bigger accounting firms. Do client’s really perceive much of a significant difference among law firms?

“Strategy is about being different. If we’re not substantially different from our competitors to our stakeholders, how well does that bode for our firm’s future? The only limits are your creativity. To survive and thrive, firm leaders must get real smart in what strategy means,” says Mark Scally, the former CEO of McGladrey.

4. Does your current strategic plan cause other competitors to see you as a “leader” or a “follower” in your particular market area(s)?

And wait. There is yet another issue here. We haven’t even begun the discussion of where all of this goes “when” the economy begins to slow down – and it is.

5. Does your current strategic plan make provisions for what you will do when the next recession hits?

Of course, there are always those firms who are being told that the answer to this dilemma is simply to find the right merger partner. Unfortunately, simply entertaining merger invitations may help you inflate your gross revenue numbers, but it is no guarantee that it will do anything substantive to correspondingly enhance your profitability. Growth is a worthy goal, but there is always a tendency to mistake the revenue embellishment at the expense of bottom-line enrichment. Growth is the game, but profitable growth should be the scoreboard.

Getting bigger does not generate increased revenue-per-lawyer or necessarily even produce more profit per partner. And size does not inoculate a firm from strategic inertia.

## **RECOGNIZE THE INERTIA THAT EXISTS**

Whether we choose to call it the digital economy, the knowledge economy, or even the new economy, it seems clear that we are in the throws of an economic revolution as profound as that which gave birth to the modern age.

Wherever you look within the profession, you will see two kinds of firms: laggards who have fallen behind the change curve, and challengers who are in front of the curve or at

least at the leading edge of it. The laggards fail to see the future coming. They fall out of the driver's seat. They cede the role to somebody else and then fight to catch up.

If your firm gets caught behind the curve, it wasn't because these trends weren't visible; it's because they were ignored. The huge challenge remains that many firms are having their best revenue years ever, and unless there is acute "pain" there is little incentive to change. History proves that laggards only grab for the new once they are totally convinced the old doesn't work anymore.

And the old doesn't work anymore!

Today, those in need of news are no longer tied to newspapers, magazines or any printed media. In the new reality, news as a service is provided in print, digital and graphic forms, over the air, through the air, and under the ground. A person's need for banking and insurance services remains, but many physical banks and insurance companies have become somewhat irrelevant. Meanwhile, the end-user of legal services is no longer uniquely tied to the services of a particular law firm or a lawyer.

Therein lies the greatest hurdle. The practice of law more than any other profession or industry, and many law firms irrespective of size or geography can be counted upon to remain frozen in time. There are some generic reasons, if not excuses, for many firms not to take action. From their early days in law school, lawyers were rewarded for success and still are today, based on their ability to look backward in history to find precedent, to find the experience-based rule that will control the adjudication of the situation at hand. Lawyers appear to be driving down the information superhighway with eyes firmly transfixed on the rear view mirror. The need for change is not welcomed and the more dramatic the change required, the more acute the resistance from nostalgic past-worshippers.

In order to take decisive action, most firms have some acute change hurdles to overcome – hurdles we have come to label as denial, perfectionism, precedent, competence, and agility.

- **The debilitating effects of denial.**

Many firms are in denial and the few that aren't, move very slowly. When does a firm's strategy change: usually only in response to a crisis or because of the initiative of a new managing partner.

Look for signs of denial, arrogance or nostalgia – the three deadly sins of profitable growth. Take for example, the views of many of the Wall Street elite, who hold to the belief that the New Economy businesses will gravitate to them as the tech industry matures.

Meanwhile, much has been made of a few firms like Wilson Sonsini operating under a new "paradigm" (don't you just hate that term?). Whatever term you decide to attach,

there is no escaping the hard reality that Wilson is one of the star performers (1990 to 1999) that has enjoyed above average RPL and PPP growth, and that is without any of us knowing or factoring in, how much additional wealth is being created through their having accepted client equity.

Will they continue to be star performers? Who knows. Is this difference in style one of new economy versus old economy? We think not. We think that it is more attributable to a willingness to embrace change and innovation. In many firms we have a generation of stewards rather than entrepreneurs.

The power of denial is most prevalent in what you do, when you don't know how to profitably grow. So a firm's response becomes let's do more of what we have been doing, or let's cut costs, or let's just merge.

- **Beware the handicap of perfection.**

One of the biggest drawbacks to embracing change and innovation is the lawyer's natural mindset and desire to get things right the first time.

This may be a highly desirable trait in legal work. If you are preparing pleadings in litigation or a contract in commercial transactions it is essential to have a watertight document – that is what your client is paying for.

Unfortunately, lawyers approach websites, e-commerce, or new market initiatives in exactly the same way, striving for perfection from the outset and unwilling to go public until they are entirely happy. The downside of this approach is that projects overrun their budgets and timetables, and opportunities are lost as other firms steal the initiative and the limelight with their own projects.

Today, we operate in a rapidly evolving market, where organizations have to reinvent themselves and their business models on a continual basis. So rather than striving for perfection, it is better to launch a service offering as soon as possible – to gain “first-mover advantage” and to throw the competition into disarray – then worry about ironing out every wrinkle. The shape of any new offering can change dramatically, over time, as clients start to generate feedback.

- **The danger of precedent.**

“If the medical profession was based on precedent, we would still be using leeches.”

Many great firms began with the initial vision of one of their founding partners. That vision was most often, the creation of a single individual and became the essence of “how we practice law and how we do business” in this firm. Anyone who has ever spent time in a number of different firms has come to recognize that “how we do business around here” is rarely codified but often deeply rooted within the subtleties of the firm's culture, operating style, and campfire stories. This vision, over time, can become an intellectual



straightjacket as the firm misses out on exploiting opportunities due to blindspots caused by its reliance on history and precedent. The last seven words of a dying firm are, "we've never done it that way before."

For those who built the firm's past successes, the temptation to preserve the status quo can be overwhelming. The battle is not globalism versus regionalism, it is innovation versus precedent. The practice of law is about following precedent, but strategizing is about breaking new ground.

A quick example makes this point rather succinctly.

Strategy requires choices. But it's not good enough just to be different. You've got to be different in ways that involve trade-offs with other ways of being different. The trouble is that firms hate making choices, because doing so always looks dangerous and limiting. They always want the best of all worlds. It is psychologically risky to narrow your range of services, to narrow the range of prospects you are targeting. And this unwillingness to make choices is one of the biggest obstacles to crafting a winning strategy.

A firm simply cannot be all things to all people and do a very good job of it. Gone are the days of trying to be all things to all clients. Here are the days of having a few signature practice areas with corollary supporting specialties.

Going even deeper, firms must take inventory to determine which clients are most profitable and which are buying services that add the highest value. Those profitable relationships should be expanded at the expense of relationships with clients that buy marginal value-added work. It will become too expensive for firms to service minor clients, which should be discarded for marginal firms to scavenge or somehow make profitable through focused niche practices.

Let's reference a few comments made for a recent interview from The Legal Times.

"Historically, like a lot of firms when asked, 'Who are you?' we would say we are a large, full-service law firm," says Francis Burch Jr., co-chairman of Baltimore's Piper Marbury Rudnick & Wolfe. "About three or four years ago, the light started to go on that that didn't mean a whole lot -- and was going to mean less as the process of globalization and consolidation and convergence continues." Today, Piper touts core practices in technology, real estate, and national litigation. "We have lots of discrete specialties," Burch says. "But in every case, they must further the firm's ambitions and support one of those three broad concentrations.

Among the large firms in the fierce competition for high-end legal work, there is little room and even less tolerance for practice areas with mediocre profit margins. This year's jump in associate salaries has only put the situation into starker relief. The salary increase, Burch says, "makes you think and behave more strategically. You invest in the development of practices where [billing] rates are not going to be the principal issue, but

where clients are looking for expertise and where you have a very strong story to tell. For the best work for the best clients, I'm not in discussions about rates," he says.

We contrast that, with the views of a firm of equal size and similar geography, Washington DC's Hogan & Hartson.

Chairman Bob Glen Odle in the same interview, noted that for both the intellectual satisfaction of firm lawyers and for financial reasons, a broad array of practice areas is essential. "My view is that any law firm that says 'I am going to be this and nothing else' is going to the graveyard," Odle says.

Well he may be right for his firm, but the hard numbers indicate that Hogan & Hartson achieved a 6.25% growth in RPL over the past 3 years, while Piper Marbury is another of those star performers having realized 15.1% growth in RPL over the same period.

- **The danger of competence.**

Professionals are understandably discomfited when faced with the fact that the intellectual capital accumulated over a lifetime may be of little value in a radically changing environment.

Competence is the enemy of change. Many professionals get locked into a successful mode of behavior and in some cases, arrogant manner. They are the ones who will do everything in their power to fight change because they are in love with the status-quo.

Competent professionals resist change because change threatens to make them less competent. Competent professionals like being competent – that is who they are and sometimes that is all they've got. Just think of the risks that come with embracing anything new. A fresh approach to serving clients – one that would prevent me from maximizing my billable hours and force me to practice differently. No wonder they're in no hurry to rock the boat.

Look at what Latham's has done to portray themselves as the premier health care compliance group in the country. With the launch of Compliancenet, hospital clients are offered a resource to help them do more of the compliance work for themselves, even though it means lower legal fees for Latham. This firm recognized that hospitals don't relish having a pricey firm review their contracts and that the firm that lands compliance assignments has a better chance of doing the more lucrative work that hospitals generate. Lathams also knows that having a resource like Compliancenet allows them to enter other geographic markets.

Most competitors would say, "why would we want to invest non-billable hours developing a resource that then only serves to decrease our billable hours?" Most attorneys would ask, "who's going to compensate me for the lost hours that I spend developing this resource?" Daniel Settelmayer, the Lathams attorney who spearheaded

the development of Compliance.net simply says, “This is a simple idea that anyone else could have just as easily developed. But we did it first.”

Getting ahead – then staying ahead – is the basis of strategy. Many firms have atrophied in their ability to think and act strategically. We consistently evidence so much short-term thinking. It’s all about immediate results. Too many firms seem to have lost the habit of investing for their future.

Increasingly, the firms that will be the true leaders will be those who reshape and redefine the profession. A good strategy makes the firm different. It gives the firm a unique position. And a unique position involves the delivery of a particular mix of value to some array of clients.

- **Over-reliance on Agility.**

“The world changes,” says the managing partner of a top 20 firm. “And an institution like this, which has been around for over a hundred years, survives and thrives because it is able to adapt to the changes that take place.”

We say, “Good luck.”

Most believe that they can quickly adapt if anything dramatic finally manifests itself. And agility is great, but if you become nothing more than agile you will remain a perpetual follower – and even fast followers find few spoils. The goal is not to speculate on what might happen, but to imagine what you could make happen.

Dare To Be First. “The first one to the future has the best view. There is no limit to what can be accomplished when you keep looking beyond the horizon. Not just to see what’s coming next, but to create it.” Those are the headlines from a recent advertisement sponsored by Hughes Electronics Corporation. And never has a message been so appropriate for the legal profession.

THE JOURNEY TO TOMORROW WILL BE AN OFF-ROAD EXPERIENCE.

Firms must reconnect with the whole idea of strategy. Success is more and more a function of making choices, and having the discipline to avoid the incredible pressures for compromise and distraction, if we’re going to compete successfully in the twenty-first century.

Unless firms have a clear idea about how they are going to be distinctly different and unique, offering something different than their rivals to some different group of clients, they are going to get eaten alive by the intensity of the competition. There was a time when markets were forgiving, but soon those with the ‘me-too’ strategies will be punished quickly and mercilessly.

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