What goes up...

Many law firms are enjoying unprecedented revenues and profits. But are we at the top of the market? Michael Herlihy, John Robinson and Tony Williams call on firms to prepare the ground for harder times

With headlines still saluting the latest record results at leading commercial law firms, it may seem churlish to raise thoughts of a downturn.

But while we have no wish to compete with economists – experts who, according to Nobel Prize winner Paul Samuelson, 'correctly predicted nine of the last five recessions' – we are willing to venture that current market conditions will not continue indefinitely. At some stage, demand in the market will cool and some firms, which are unprepared for this, will find it painful.

So what can firms do other than await the inevitable?

No business can be fully 'recession-proofed', but we believe that a health check now can provide a basis for action that will stand the business in good stead when the market turns down. Like repairing that leaking gutter at home, it may not be a job you feel much like doing in the August sun, but how you might wish you had when it is raining in November.

We would suggest a focus on people, financials, and clients/strategy.

The key in all cases is to try to see the business, its performance, and competitive position as it really is. Externally, it may be management's job to present the firm's performance as positively as possible. Internally, the responsibility is to deconstruct it as rigorously as possible. In a market whose core areas such as mergers and acquisitions and finance may be at or near a peak, this is not easy.

Clearly, some firms that are performing outstandingly can take great credit for the quality of their management. Others, though, that are seemingly doing well may, in reality, be doing little more than rising with the tide; with worrying implications for what may happen when it turns.

As Phil Rosenzweig observes in his recent book *The Halo Effect*, when things are going well, we are all prone to over-emphasise the contribution of management and downplay the role of external factors. Prudent managers will resist this.

For example, revenue growth in a year of 10% might look like an excellent performance. A quick review of recent results from a range of larger UK and US firms for 2006/07, however, suggests that, in competitive terms, growth of 10% in those markets might not represent much more than standing still. (Lower growth might, of course, still represent good performance for an individual firm depending on its starting point and strategy.)

Surely it is good news that revenues and profits are up? Yes, certainly – but where and why, and what exactly does it mean in terms of your competitive position?

Similarly, in thinking about the future, it may help to adopt the spirit of an approach advocated by the cricket pundit Geoffrey Boycott. When reflecting on the state of a game, he often urges people to consider how things would look if two batsmen were to be out in the next six balls – a negative but (other than in the case of Australia) not outlandish scenario.

So how would the business look if your two most important clients were taken over, if there were a major shift of momentum in the capital markets, or two or three key partners in a particular practice area moved to a competitor?

Scenario planning has its limits, but considering potential responses to your key business risks in advance is likely to be a lot more productive than waiting to see some smoke before you bother to figure out the fire drill.

People

Most businesses are tempted sooner or later into a recitation of 'our people are our most important asset'. In the case of a law firm, this is, unfortunately, true.

Unfortunate because, as they fail to teach you at Harvard, people are a bugger to manage. The single biggest cost and the ultimate determinant of a firm's capacity, people have a unique propensity, unmastered by any other class of asset, to lobby relentlessly for increased maintenance expenditure.

Photograph: Alamy

Feeling the pinch: the extra costs firms incur for staff during the good times will start to bite in a downturn

Increasing capacity organically takes years (around five years from student offer to one-year-qualified solicitor); acquiring it from others is costly and high risk, and reducing it at any stage prone to be both internally and externally traumatic.

No wonder that even some of the best-managed firms have struggled to manage these assets 'through the cycle' in an entirely coherent way. While the full implications go well beyond the scope of this article, at least one relatively straightforward point can be made – it is a lot easier to lose people when you do not want to than when you do.

Underperforming individuals or practice groups that might be moved on fairly painlessly in today's buoyant market may become expensively hard to shift if the supply/demand balance changes significantly.

The rub, of course, is that moving people on today, with replacements potentially thin on the ground, threatens capacity and, thereby, profit. So who in their right mind would do it? Well, arguably, someone who was seeking to optimise profitability through the cycle.

One cannot generalise; following the market to the top with capacity will probably maximise profits in the short term and may be the right thing to do, but it will also tend to increase cost-drag on the way down and should at least be compared to the alternative of managing to a quality-related capacity limit, with the pricing, product and client implications that such an approach entails.

Putting this another way – if you would not go out and recruit a known underperformer simply because there was enough work to occupy them profitably in the short term, how sensible is it to tolerate an existing underperformer on this basis?

People costs

Since the last downturn in 2001, there have been two significant changes in many firms' salary structures – assistants are paid substantially more, and there has been a considerable increase in the number of fixed-share and salaried partners.

With regard to the former, it is not just direct salary costs that have increased. In addition to the inevitable on-costs, some firms have also taken on substantial additional costs to respond to employees' various work/life balance concerns. The extra 'inches on the waistline' may not seem much in today's sold-out market but will weigh more heavily if conditions deteriorate.

Similarly, while the gearing provided by non-equity partners is clearly helpful to profits per equity partner in a bull market, it remains to be seen how painful it will be when conditions change. 'Expensive, lacking the business generation skills that would have taken them into the equity and difficult to shift' may be an overly unkind way to view these particular assets but, equally, one might want to be cautious about adding to their ranks in the short term.

Financials

A good place to start here is working capital. It is dangerous to generalise and firms will manage to their own targets, but if work in progress and debtors together exceed 120 days, there may well be something that needs looking at. As regards liquidity, having cash or overdraft facilities available to cover 60 days or say 15-20% of total annual costs is probably a sensible level of cushion for the proverbial rainy day (a few delayed large debtors, say, or a breakdown in the IT or billing system).

In terms of the profit-and-loss account, it is, again, difficult to generalise, as appropriate targets will vary depending on the nature of a firm's practice and its gearing, but, in current markets, net operating profit below around 25-30% of gross revenues might begin to prompt some questions.

In terms of costs, we have already noted the significant salary creep that has occurred in recent years. Particularly where the cost base may be changing significantly in other respects (for example, investments in premises or major systems upgrades), we would suggest some careful reflection on the impact this will have on break-even levels by practice group.

Someone always has the honour of marking the top of the market by committing to a major office move at that point – a distinction it would be good to avoid. Almost universally with overhead costs, flexibility (temporary staff, break clauses, leased equipment and the like) comes at a cost, but it also has significant value if it enables a firm to respond to changing external circumstances.

Finally, we should mention one critical but seemingly little mentioned issue – pricing. While the old days of individual partners 'making it up on the hoof' may be receding into history, we would doubt that many firms would claim to have 100% effective pricing processes.

Again, this is a topic beyond the scope of this article, but if a firm does not have a good grip on pricing decisions today, it seems unlikely to gain one in the scramble for work that may well follow a downturn. Given the impact which seemingly innocuous discounts can have on profitability even in good times, this is something firms might want to get on to their agenda now.

Clients and strategy

With regard to clients, the key, again, is dispassionate self-analysis. How many of the new clients you have won are really with you for the long haul or might, for example, be wooed away if larger rivals decide to drop prices and/or start paying them more attention when work becomes scarcer? What are you doing in the meantime to commit them to you?

After several years of high demand, in which lots of partners have been made up, how well polished are the firm's business development skills and how well prepared are people for a world in which – for a period at least – there might be more lawyers than work?

For the longer term, do you know the clients you really want in terms of sustainable success? One of the interesting things about downturns is that there are winners as well as losers. Research from both McKinsey and Booz Allen has demonstrated how businesses with a clear strategy and solid financials can make rapid competitive progress in recessionary conditions when less well-prepared rivals are distracted with short-term performance pressures.

To use a motor racing analogy, it is not about how fast you go into the corner, it is about how fast you come out. The best firms, with a clear line of sight on their long-term strategy, and having 'changed down' in good time, can be accelerating out of the downturn, while others are still struggling to stay on the road.

In this sense, the ability to anticipate events and react swiftly and decisively is a key distinguishing factor for outstanding leaders in any sphere.

So do you have a real strategic plan? Not some elegantly crafted document that is gathering dust on the window shelf, which partners quote selectively when it suits some short-term goal, but an actual live plan which people are held accountable for delivering. Assuming you do, what are the key strategic risks and opportunities a downturn might pose?

In particular, what is on your wish list (clients, lateral hires, competitive practices or merger targets) that is out of reach today but might just be accessible if competitors find themselves struggling with market conditions they have not anticipated?

Who knows, if you have prepared properly, a downturn, far from being a disaster, might be just the opportunity you have been waiting for.

Michael Herlihy, John Robinson and Tony Williams are consultants at Jomati. Go to www.jomati.com.

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Herlihy: strategic plan vital