



Mending your ways

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Is your firm suffering from falling profits?

How should you respond to the depressed market?

Tony Williams reveals the questions you should be asking in order to stave off the effects of the downturn

Traditionally, a law firm facing falling profitability has lost a few partners, refocused its business and either regained its former profitability or accepted a new level that is acceptable to most of the partners. Falling profitability is usually a symptom of something wrong in the firm. It may be caused by a disproportionately reduced workflow, underperforming partners and staff, pricing difficulties, inadequate financial controls or unaffordable investment, and most probably a combination of these.

In a buoyant period, the necessary changes can be achieved with relatively little pain. In the current depressed period, firms need to change quickly. If they do not, although they may not face imminent extinction, they do face relegation, with all that implies in terms of client, partner and staff retention.

The following 10 indicators should help to identify whether a firm faces a substantial long-term problem. Every firm will display some of the indicators, and indeed as in the case of medical symptoms some may indicate health as well as illness, so the implications of your firm's score are set out at the end.

1. Were fewer than five of your top 10 clients for this year also in your top 10 last year and the year before?

No one expects their client base to remain static, but any professional services firm will want a number of 'core' clients to provide a reasonably constant source of work year in, year out. Too much change may indicate that substantial effort is being made to get clients but insufficient effort is being made to keep them, or that you are targeting clients for one-off transactions that are unlikely to have a consistent flow of work.

Clients also gain comfort from the company that you keep. If many of your clients are reviewing their panel or relationship and excluding you, when it becomes known, this can cause other clients to reconsider your role. Conversely, very little or no movement of the top clients may be a warning of stagnation or complacency. The firm may have stopped developing its clients and looking for opportunities to expand its relationships as a whole, instead relying on its annuity base of work for individual clients or groups, which may in turn produce its own problems.

2. Have two or more of your top 10 clients been taken over or changed general counsel/chief executive officer (CEO) in the last 12 months?

The takeover of a client, especially if contested, can be a bonanza for legal fees. However, if it was very hotly contested your removal as the company's lawyer may follow immediately after the departure of the target's directors. If you perform especially well, you may do enough to stay on the new group's panel or even, in time, become the lead adviser; but this relies more on the failures of the incumbent lawyers than your own brilliance. Banking on others' failure is a risky approach.

A new general counsel or CEO is likely to want to stamp their authority and views on the organisation. A relatively painless way to do this is to shake up the external advisers. If you have a good reputation in the organisation and many points of contact with different specialists in your firm, particularly at middle and senior management level, you will be more secure, especially if the new person sees you as an ally in their transformation process. A 'this is the way we always do this for you' approach to the new broom will result in your being swept away.

3. Has your profitability per partner, as compared with your peer group of firms, increased less (or reduced more) over the past two years?

Law firms are often anxious to show that their profits are increasing. This is understandable and, in the short term at least, firms that increase profits keep their partners happy. However, the real test is how you are improving compared with your peer group. To increase profits by 10 per cent sounds good, but if it is the top of the market and your peers are improving by 25 per cent, not only are you substantially behind, but you are also in a weaker position when the downturn comes.

Profitability is not just a partner issue. The younger lawyers realise it will affect their prospects and may start to look elsewhere. The best graduates may not even apply. The cycle of decline has begun.

4. Have three or more of your partners moved to more profitable UK or US firms in the past year?

Some movement of partners is to be expected and is indeed healthy. But if good partners, especially good young partners, are moving to other firms, you have to take this seriously. Moving for more money is often the excuse given. However, it is usually only one factor for a UK lawyer. Lack of appreciation or status, a feeling of drift in the firm or even client pressure are far more likely to be the real motivators for change.

In a severe downturn a firm can be expected to lose, say, 10 per cent of its partners. The challenge for the management is not to prevent this, but to ensure that the 'right' 10 per cent go. Inaction will almost certainly result in the 'wrong' partners leaving - the most able, the rainmakers, the ambitious - and then kneejerk decisions being taken to stem the flood.

Again, these issues do not just affect partners. Associates and trainees are often better and quicker at reading the signs than the partners. The best will go even in a tough market.

5. Have you changed your profit allocation system within the last two years?

I do not suggest that profit systems should never be changed. Change does, however, create uncertainty and winners and losers.

If not undertaken in a rising market, any change is more likely to be about dividing a smaller cake in such a way as to keep the 'stars' motivated. By definition, others must get a smaller slice. They may consider themselves 'stars' and resent the change. Merit-based rewards, if not widely accepted and demonstrably fairly allocated, can also breed resentment. Is this tinkering because the firm's management is unable or unwilling to deal head-on with the non-performing partner issues in the firm?

The lose-lose result is to change the profit system at the behest of a successful team but to fail to deliver sufficient profit to keep them. They leave, the other partners are demotivated and the credibility of the management is shattered.

6. Do you have a strategy to be a top-tier international firm?

So many law firm strategies seem to envisage the firms becoming top-tier international firms. For the magic circle London firms, and for a few other UK firms, this may be a credible approach. For the others it is ridiculous at best, or an expensive distraction at worst.

Fortunately for most such firms, the strategy is presented by the managing partner at the partners' retreat and then forgotten, so no real harm is done. A firm needs to really understand its ability, client base, reputation, ambition, preparedness and ability to invest if it is to have a credible strategy. It should stretch the firm but also be achievable and credible. If it is to mean anything, it has to drive what the firm does and, probably more importantly, what it does not do.

An unachievable stream of 'me too' nonsense may sound good at the partners' conference, especially if the partners drank well the night before, but will be ridiculed and/or ignored by Monday morning.

7. Has your investment in international expansion failed to produce any tangible results?

Whatever your firm's strategy, the cost of pursuing it has to be producing tangible benefits for the firm. This may mean picking some easy wins in order to encourage the more sceptical partners to keep faith with the strategy. If the firm is investing abroad, it needs to know what it wants to achieve and how it will know whether or not it has. Management is often tempted to avoid clear measures but they are clearly the best way of judging success. Even if the milestones are not met, this does not mean that the approach is flawed, but that it should be explained. Substantial cost with no clear results or coherent strategy will concern partners, especially if the management seems more concerned by these investments than the issues affecting the more established and profitable parts of the firm.

8. Has your cash position deteriorated by more than 10 per cent over the past year?

Lawyers seem incapable of understanding the value of cash. They do not seem to understand that work in progress is not an amount billed and an amount billed is not cash until it is paid.

In a downturn, clients do understand the value of cash. They will delay paying bills. They will raise queries. If your contact at the client is made redundant the replacement will deny all knowledge of the matter. Meanwhile, your partners will be getting their drawings (often based on last year's record performance), salaries will be paid and rent will be due.

For a firm turning over £100m per annum, a modest decline in turning work in progress into bills and bills into cash of one week each, adds £4m to its cash requirement and costs the firm an additional £200,000 in annual interest costs.

If you have just invested in a practice management system (ho ho), your accounts team may be diverted to its teething problems. If you are moving premises (see question 9), time recording, billing and collection all face disruption just at the time when the costs of moving, the fit-out, the new IT system and the 'statement' artwork in reception have to be paid.

A cash squeeze can arise rapidly if you do not manage your cashflow well. Although borrowing is not expensive at current interest rate levels, you cannot assume that your bankers will extend or even maintain credit to a firm that is not managing its cash. If this occurs, partner drawings will be substantially reduced and even capital calls made. Partner movement then becomes inevitable.

9. Have you agreed to take new, larger office space within the past two years? (Or worse still, have you failed to get rid of your existing space?)

Property watchers say look out for the cranes. The more you see the more likely a property recession. There is an even more reliable indicator: look for the law firms moving. Lawyers almost invariably sign up for new, much larger space at or near the top of the cycle.

To be paying rental costs that are 5 or 10 per cent more than your competitors means you have to outperform them in all other areas just to keep up with them. When fit-out costs, business rates and service charges are included, space amounts for around 15 per cent of a firm's overheads.

If expansion space has been taken at a high rent, the impact is compounded, as it is unlikely that the space will be profitably occupied until the next turn of the cycle. With the property market turning down, if existing space has not been offloaded then disposing of it will take far longer and may require a rental subsidy. If you are vacating premises at the end of a lease the landlord is likely to be much more demanding on dilapidations in the absence of an incoming tenant.

10. Has your managing partner or senior partner been in office for at least five years?

Experience is important, but a downturn requires decisive and firm action. A long-term incumbent may be reluctant to see their pet projects cancelled. They may already have lost the trust or support of their partners, or the partners may be just too polite to tell them. A completely inexperienced person in the role may be just as bad. The key issue is; can the managing partner take decisive action, act fairly and retain the trust and confidence of most of the partners? Dither and die.

How did you score?

Every firm will have answered “yes” to some of these questions. No individual answer means your firm is in trouble, it is the cumulative effect that is important. Partners and others rarely leave a firm because of short-term issues; they leave because they feel undervalued, they see their career development impeded or they are worried by the culture or direction of the firm. A well-run firm can address a range of problems and emerge stronger and even more determined to succeed, but...

- 0** It is almost inconceivable that any substantial firm has not encountered one of these issues in its recent past. I hope you are happy in your fantasy world.
- 1-4** There is probably nothing serious to worry about. Indeed, your firm may be encountering a healthy and manageable level of change. The key issue is: how are you, your partners and potentially your clients responding to these challenges?
- 5-8** These are worrying signs. A grip needs to be taken of the firm now. If not, prepare to be relegated to the next tier of firms (if you are lucky).
- 9-10** If you are in the office you may be noticing that things are rather quiet. Please turn off the lights on your way out.

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