

Hope for the best, plan for the worst

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During the 25-year bull run in legal services until 2007, law firms could expect their revenues and profits to grow at a compound rate of double the rate of inflation. Downturns and recessions caused a setback but usually affected firms for only two financial years before the growth trajectory was resumed.

But all this changed after the latest financial crisis. Growth can no longer be assumed and even if revenue growth is achieved, this is often via mergers or new offices rather than 'same store sales'.

Based on The Lawyer 100 figures, the revenue of firms 51 to 100 has risen by 8.3 per cent in the six years from 2007 to 2013 or just over 1.3 per cent every year. For firms 11 to 50 the revenue growth in the period was 35 per cent and for firms one to 10 it was 56 per cent. Given the record number of UK law firm mergers during this period, much of this growth is the result of consolidation.

Low expectations

What can firms determine from this? First and foremost that they need to plan on the basis of a low growth legal economy, despite recent positive growth forecasts from The Law Society. Firms need to ensure that their costs are rigorously controlled, that any 'investment' can be properly justified by its likely return over a credible timescale and that their charging and billing arrangements are fit for purpose.

In addition, they need to acknowledge that growth will come primarily from taking market share from others, so firms will need to defend their existing client relationships while attracting new client prospects with rigour and discipline.

Mergers or new offices may be part of the response but only if they form part of a clear and coherent strategy. Growth in revenue that doesn't grow or protect partner incomes is likely to be an expensive distraction. However, as part of any strategy the partners need to consider the risks and benefits of the status quo because in a competitive and consolidating market, not adapting to change, while initially comforting, can be the most dangerous course.

Low growth also imposes real pressure on a firm's remuneration system. Primarily lockstep firms assume a level of annual unit inflation as partners move up the lockstep. When profits grew at double the inflation rate, this unit growth was possible and the value of a unit also increased.

Now many firms can have growth in the number of profit units or growth in the profit per unit. Not both. This means that the increasing rigour applied to partner performance and unit allocations since the downturn will continue and in some firms be redoubled. No matter how profits are allocated, there is a finite pool of profit available for distribution. So if some partners are overpaid, others must, by definition, be underpaid. In a relatively fluid recruitment market, underpaying a star of tomorrow is dangerous.

The reality is that addressing these issues will buy time but many firms need fundamentally to re-examine their business model to respond to this new environment. Every aspect of the business may need looking at.

Questions time

The key questions a firm needs to ask are: what piece of the legal market do we have and want, what do our clients expect from us in terms of capability, service and price, how defensible is our position against our competitors including new entrants, and how can we organise ourselves to make an acceptable return for ourselves and to fund necessary investment?

Big questions that should necessitate a range of difficult decisions, but decisions that will need to be made to ensure the future prosperity and survival of the firm.

Firms are experimenting with project management, process engineering, on shoring, contract lawyers and paralegals but this is just the start of what will be a major review of operations. Technology will have an important role to play in this process. These changes will not replace the experience, skill and judgement of good quality lawyers. Indeed, we may discover that in the old model we seriously undervalued the price clients are willing to pay for those attributes while overcharging for process or journeyman work. Making change in a relatively conservative and profitable profession will be challenging but is achievable.

The good news is that the 'best' lawyers will always be in demand from good clients but 'best' like beauty, will be in the eye of the beholder.