Law Firms in Transition 2018: Data Highlights

Conducted in March and April 2018, the *Law Firms in Transition Survey* polled Managing Partners and Chairs at 801 US law firms with 50 or more lawyers. Completed surveys were received from 398 firms (49.7%), including 45% of the 500 largest US law firms and 52% of the AmLaw 200.

The full survey includes sections on market forces, leading change, productivity, profitability, lawyer staffing strategies, efficiency of legal service delivery, pricing, and financial performance.

Following is a summary of key findings.

Section 1: Market Forces

Overwhelming majorities of law firm leaders believe more price competition, commoditization of legal work, new forms of competition and smart technologies are permanent changes to the legal market, continuing a multi-year trend. But in the face of that daunting landscape, there are signs of optimism:

- Only 51% of firm leaders expect smaller annual billing rate increases to be a permanent trend, down from 64% last year.
- Only 39% of firm leaders expect slower profit per partner growth to be a permanent trend, down from 47% last year.

The pace of change in the profession is expected to remain brisk. This year, for the first time, not a single respondent expected the pace of change in the profession to decrease.

Demand growth remained slow and was unequally distributed, with only 40% of law firms reporting positive demand growth in each of the last three years – a far cry from the pre-recession years marked by strong demand, robust annual rate increases and reliable growth in partner incomes. The fact that most firms failed to put together three consecutive years of demand growth or revenue per lawyer increases is a vivid illustration that the market has become less stable and much more challenging.

Revenue per lawyer gains that were driven by substantial rate increases may cause continued erosion of demand, absent corresponding increases in value delivered:

- Corporate clients doing more work in-house and continued erosion of demand are seen by 65% of firm leaders as permanent trends.
- Corporate law departments continue to redirect work from outside counsel to in-house staff, with 70% of law firms reporting they have lost business for that reason.

Differentiated firms significantly outperformed non-differentiated firms, but only half of law firms think they project a distinct and compelling value that differentiates them from other similar law firms. The 50/50 split was consistent across all size ranges except the very largest firms, which are differentiated by size. In the present environment, we think it is imperative that law firms be able to clearly distinguish themselves from competitors in ways that matter to clients. We think defining and communicating meaningful differentiators is a must for every firm and practice group to avoid the forces of competition, commoditization and substitution.

Section 2: Leading Change

A consistent theme over the past ten years has been law firms' general unwillingness to lead clients rather than merely responding to client requests. Corporate clients continue to give law firms low marks in terms of firms' seriousness about changing their legal service delivery models to provide greater value to clients.

Why aren't law firms doing more to change the way they deliver services? Mainly because partners resist change – 69% of firms cited this reason, up sharply from 44% three years ago.

Innovation in law firms appears to be declining as partner resistance increases. This year, fewer firms said they are actively engaged in creating special projects or experiments to test innovative ideas or methods. About six in ten firms are including innovation initiatives in firm strategic plans or budgeting time and/or money in support of innovative projects. The larger the law firm, the more likely they are engaging in structured innovation, probably because they have more incentive to do so (to acquire and retain large corporate clients and maintain desired margins) and more resources to dedicate to the effort.

Curiously, law firm leaders' confidence that their firms are fully prepared to keep pace with the challenges of the new legal marketplace has steadily declined, from a high of 24% expressing high levels of confidence in 2011 to a low of 5.6% expressing the same level of confidence this year. We think that as firm leaders have tried to implement various programs and initiatives over the course of this decade, they have found it much more problematic than they anticipated and become more circumspect. As the proportion of firm leaders expressing high confidence declined, the number expressing low confidence increased sharply from 8% to 33%.

Section 3: Productivity

Amid slow demand growth, the survey indicates continued high levels of overcapacity and underperformance. Partners are underutilized in most law firms and nearly half of all firms failed to meet their total annual billable hours target for 2017. Not surprisingly, firms that said their partners were sufficiently busy were much more likely to report strong profitability gains in 2017.

Most firms (90%) are trying to deal with underperformers by reducing their compensation – a strategy that often fails to deal with root causes. Removing chronic underperformers has resulted in significant performance gains in 84% of firms that have done so, compared to 39% effectiveness in firms that reduced underperformers' compensation.

Section 4: Law Firm Profitability

Again this year, firms that use profitability data for management decision making outperformed firms that do not, in terms of profit per equity partner gains. Still only half of law firms are using profitability data as a practice group management tool.

Most firms have made greater investments in business development in hopes of improving profitability. Unfortunately, those investments have delivered significant improvements in performance in only 37% of the firms.

There is much to celebrate, however. In our second year of tracking the effectiveness (not just incidence) of ten profitability tactics, we find that more firms reported significant improvement as the result of each tactic, compared to last year.

We will continue to gather and report on the effectiveness of firms' activities going forward and expect continued positive movement in these trends.

Section 5: Lawyer Staffing Strategies

Notwithstanding widespread overcapacity, most firms are back in growth mode, with 60% of firms saying growth in lawyer headcount is a requirement for their firms' continued success and 60% reporting actual growth in lawyer headcount last year.

Six in ten firms said they staff for average annual demand (59%) rather than for peak demand (10%) or an expectation of growing demand (13%). Only 14% of firms said they staff for average demand with contract lawyers or other temporary lawyers available to cover peak periods – a flexible approach that we think is wise, depending on the nature of the work and availability of talent.

Overall, 58% of firms are using part-time lawyers and 55% are using contract lawyers to at least some degree, with usage much more prevalent in larger firms. Alternative staffing of this type has delivered performance gains in a majority of firms that have tried it. The effectiveness rate increased from 2017 to 2018 for each of seven staffing tactics employed by law firms nationwide.

Section 6: Efficiency of Legal Service Delivery

Nearly unanimously, law firm leaders see a need to focus on improved practice efficiency – a more assertive effort to realign pricing, staffing and efficiency with client expectations. So far, only 19% of firms are systematically reengineering their work processes but doing so has already resulted in significant performance improvements in 43% of those firms.

Firms that have committed to "ongoing project management training and support" reported significant improvements in firm performance as a result of their sustained investments. Short-term or episodic investments were not shown to deliver anywhere near the same results.

Whatever efficiency gains are realized, firms should be diligent about sharing or replicating the improvements to benefit other clients. Most firms do so at least sometimes, but only 13% of firms do so routinely.

More than half of all firms are now rewarding efficiency and profitability in compensation decisions – which we commend and endorse.

Section 7: Pricing Strategies

We continue to see heavy discounting and commoditization:

- 62% of firms reported discounting their rates on at least 21% of fee revenues.
- 21% of firms reported discounting their rates on at least 50% of fee revenues.

Discounted, capped, or alternative fees should be routinely linked to changes in how the associated work is staffed and delivered. Only 42% of firms reported such a linkage – but those that did were more likely to report profit per equity partner gains.

Most firms are developing data on their "cost of services sold," but relatively few (29%) have seen it translate into significant improvements in firm performance. We see this as a huge missed opportunity.

Section 8: Financial Performance

Revenue per lawyer and profit per equity partner are important indicators of firm health and are highly correlated. Firms that said their revenue per lawyer was up in each of the last three years were dramatically more likely (84% vs. 44%) to report increased profit per equity partner in 2017.

Profession-wide, we continue to see a cohort of firms thriving, a similarly sized cohort languishing, and larger firms outperforming smaller firms on all three measures of financial performance:

- 38% of firms reported gross revenue increases of +4% or more in 2017 – 32% reported gross revenue was flat or down.
- 29% of firms reported revenue per lawyer increases of +4% or more in 2017 – 35% said RPL was flat or down.
- 35% of firms reported profit per equity partner increases of +4% or more in 2017 – 39% said PPEP was flat or down.

Realization against standard rates was up in 2017 in 38% of firms, flat in 45% and down in 17%, with no material difference between larger and smaller firms.

Bonus Question: Non-Lawyer Ownership

Each year, we ask a special bonus question on a forward-looking topic. This year, we find that few law firm leaders think non-lawyer ownership and capital investment in law firms would be a plus for their firm (17% think so), the firm's clients (30%), US citizens generally (25%) or the US legal profession (24%).

Appendices

The appendices include interesting correlations that we'll keep an eye on going forward.

Appendix 1 shows similarities and differences between smaller and larger firms as to their responses to the changing legal landscape. Larger firms are doing more of just about everything and were much more likely than smaller firms to report PPEP gains in 2017 over 2016.

Appendix 2 introduces the premise that (1) larger firms, (2) innovative firms and (3) differentiated firms outperform smaller, non-innovative and non-differentiated firms in terms of financial performance and effectiveness of change efforts.

- Appendix 2A shows that larger firms are not only doing more to pursue changes in the areas of pricing, staffing and efficiency – they are more successful at what they do.
- Appendix 2B shows that innovative firms – those that said they are actively testing innovative ideas and methods – outperformed non-innovative firms on both client demand and productivity measures. Innovative firms are more likely than non-innovators to be pursuing each of 20 change tactics and their efforts have been more effective in 16 of 20 categories.
- Appendix 2C shows that differentiated firms are almost twice as likely as non-innovative firms to have experienced consistently increasing demand over the last three years and their change efforts have been much more effective.
- Appendix 2D attempts to quantify the variation in overall effectiveness due to firm size (lowest variation), innovation (higher) and differentiation (highest).

Appendix 3 shows the ten-year data series for each of 20 market trends that have been tracked by the *Law Firms in Transition Survey* since its inception in 2009.

About the Authors

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About Altman Weil, Inc.

Founded in 1970, Altman Weil, Inc. is dedicated exclusively to the legal profession. It provides management consulting services to law firms, law departments and legal vendors worldwide. The firm is independently owned by its professional consultants, who have backgrounds in law, industry, finance, marketing, administration and government. More information on Altman Weil can be found at: www.altmanweil.com.

The 2018 Law Firms in Transition Survey

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A copy of the survey can be downloaded at: www.altmanweil.com/LFiT2018.

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