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2018 SURVEY OF THE LEGAL MARKETPLACE

by

Smock Law Firm Consultants

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SMOCK
LAW FIRM CONSULTANTS

AND THE CAISSONS KEEP ROLLING ALONG, BUT SIGNIFICANT CHANGE AFOOT

The Results of Smock Law Firm Consultants' Survey of the Legal Marketplace

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This document presents the results of Smock Law Firm Consultants' (SLFC) annual review of the national (US) legal marketplace. It is based on interviews of either the Managing Partner, CEO and/or the Executive Director/COO, or both in 41 law firms – midsize, large midsize, and large. We also based our comments on our continuing management consulting assignments in the national legal marketplace and a review of recent market literature on last year and the expectations going forward.

Sections of this monograph include a summary of our findings and recommendations; the methodology used; 2017 results and the reasons for those results; 2018 expectations and management areas of emphasis for 2018; longer-term issues and concerns; and, finally, SLFC's comments and recommendations.

SUMMARY

The schematic following this page is a summary of this monograph. It responds to President/General Eisenhower's long-standing directive to his staff that if you cannot boil it down to one page, it probably does not need to be known. In our day-to-day consulting practice, we rely on this one-page approach in client assignments and hope you can see how it organizes a lot of information together in a simple and focused manner.

METHODOLOGY

While there are certainly a number of methods you can use to find out how firms did and how they expect to do, we have settled on an interview focused approach. Specifically, we interviewed key managers in 41 law firms - either the chief attorney leader/manager (Firm Chairman, Managing Partner, CEO) or the chief non-attorney manager (Executive Director, COO), or both. The interviews were short into the point – less than 30 minutes. We asked about 2017 results, 2018 expectations, and longer-term issues. And, we promised confidentiality (no attribution or identification).

2017 RESULTS

As is always the case with a wide distribution of interviewees (41 firms – many with multiple interviewees), the results vary. However, a very large majority (considerably greater than 80%) hit their budget or did better. While generally this year, the larger (or largest) firms did better than the smaller firms, that was not a cut and dry differentiation. Some smaller firms did exceptionally well and some larger firms were disappointed in their results – but generally, size was a positive factor in performance, probably more so than we have seen in prior years.

Revenue results ranged from generally small drops to some dramatic increases (e.g. – revenue increases over 20%). Partner income increases tracked revenue increases, but the percentages of partner income growth (with some very significant exceptions) were not as strong as the revenue increases (so, the expenses are going up). A surprising number of firms had their best year in 2017 – *"best year ever; fabulous year, partner income increased greater than 10%; our largest RPL increase ever; and solid growth in all offices and most practices."* Four trends became very evident:

- For many of the firm's interviewed, these generally positive (or very, very positive) results came in the last half of the year with *"off the chart increases"* in the last quarter – *"we finished the year with a bang that we have never seen."*

- With few exceptions, these good results were more evident in the transactions practices (corporate, M&A, real estate, private equity, etc.) or the specialty and industry focused practices – *"transactions results were way beyond our expectations."*

- The problems of many litigation practices continued. While some firms' litigation practices did have good years (*"contrary to what we read, we had a great, great year in litigation"*), that generally was a function of cashing in on large cases, not consistent, well marketed litigation practice growth. Most litigation practices stayed down and they expect to remain so.

- And again, average billable hours across firms' timekeepers continued to trend down. Not only was it a function of the work not being there (as in litigation) and the increased need to spend more time in marketing and practice development, but also the recognition that – across the board – attorneys do not want to work as hard as they used to.

- Again, virtually every firm raised or tried to raise their rates. Generally, those raises held – at about 2% at the low end and about 5% at the high-end. This may not seem like much, but in comparison to the early 2000s, it represents a significant opportunity to bump up revenue.

- While raising rates does contribute to performance, the larger firms interviewed pointed out that they are managing their businesses much more effectively – in terms of profitability, pricing, broad use of data analytics, managing cash, focusing on team performance, and better space utilization.

- On the negative side, mentions were made of *"outdated branding and marketing efforts,"* the cost of increasing technological capability, and, in one case, a failed merger in 2017.

As in prior years, the interviewees did not know how well or how poorly their competition did, primarily because word or market intelligence had not yet leaked out in most markets. But, most felt that their competition did reasonably well and with the exception of *"off the chart"* performers, they felt that competitors' performance resembled their own.

The end result of this generally positive performance in 2017 was that partners are happy; defections existed, but were minor in nature; and, because of the extremely strong fourth-quarter results (virtually across-the-board), most interviewees are bullish on the near-term future. And because of these positive experiences, most firms are more bullish on lateral acquisitions than they have recently been.

AREAS OF MANAGEMENT EMPHASIS IN 2017

We asked these firm leaders what they emphasized in achieving these positive results – again, particularly at the end of the year.

- Certainly, the **rate increases** mentioned above were important. If you have a 2% to 5% built-in revenue increase, you have a good running start on other industries and professions.

- There was a continuation of the trend from the last few years of a **focus on profitability** and managing the various factors that influence profitability (including all of David Maister's big five – utilization, rates, realization, margin, and leverage). Such things as improving billing practices, focusing on accounts receivable, and upping collections performance all had tangible and positive influences.

- Across-the-board and even in small or midsize firms, there is a considerable improvement in the **effective use of management data**. This leads to information that influences better pricing – and improved pricing was a key factor in the profit improvements noted.

- Surprisingly, many firms mentioned that successfully dealing with **succession issues**, particularly at the client level and with client relationships, enabled them to expand their business from longtime clients.

- A number of firms felt they had decidedly, particularly in the last 18 months, improved their ability to dealing with both **underperforming partners and practice group management effectiveness**. As one firm stated, *"we have a whole new generation of practice leaders and they represent a significant improvement over their forebears."*

- **Improved technology and cyber security effectiveness** has had a significant impact on performance – both financially and in terms of quality and responsiveness. Some interviewees felt they had clearly upgraded the skill sets and performance of their IT personnel in 2017.

- A number of the larger firms mentioned and underscored **improved space utilization** (both in terms of cost and productivity improvements).

- Another focus area that many believed influenced the positive results, particularly near the end of the year, was dramatic **improvements in marketing effectiveness and in organizing and focusing on specific industries and market areas**. Marketing efforts were much more focused on areas that can produce a tangible return, rather than merely supporting the squeaky wheel (which, for many years, was most firms' standard approach to marketing).

- Although we have consistently been skeptical of lateral partner additions as an effective growth strategy, a number of the interviewed firms felt that they have attracted very good laterals and given them an opportunity to perform (and they have). So, **improved lateral effectiveness** is another successful area of focus.

- Improved activities in recruiting and retention have given firms an opportunity to more effectively **focus on diversity and inclusion** and emphasizing being an employer of choice.

- Finally, and although this factor has been a clear trend in prior end of year analyses, there was a noted **continuing improvement in client relationships**, listening to clients, and focusing on their needs.

EXPECTATIONS FOR 2018

As most know who read this annual monograph, the most common response by both CEOs and COOs for expectations for the next year is *"cautious optimism."* This can be expected because people cannot foretell the future (and if they could, they should invest in the stock market, not manage a law firm) and there are always good rational reasons to be conservative. In this case, we heard cautious optimism from many again, but we also heard some pretty strong positive comments and expectations.

- Most of the people interviewed had seen the last 3 to 6 months of 2017 turn out to be remarkably positive. So, given a variety of factors (including their recent success, the positives from the tax law, continued emphasis on those management strategies that are working, and - once again - a healthy rate increase), indicate that 2018 is probably going to be pretty darn good, if not great. There is an expectation that the strength in transactions (across-the-board – that is, all of the transactions practices) will continue.

- And, most interviewees felt that the positives spoken about in 2017 had and are still having a positive impact and they should continue to have that impact for all of 2018. For example, a number of firms that they had really made progress in better planning, managing, and evaluating their practices and practice/industry groups and better using data to isolate profitability improvement opportunities and manage their projects.

- Yes, there are potential negatives out there – continued pressure from in-house counsel, unknowns in the economy, the recognition that litigation is not going to turn around in the very near future (and many litigators are sitting on the beach looking at each other and wondering what to do next), the potential for a recession and downturn, the continued difficulty (and managerial cowardice) in getting rid of underperforming partners, and the inability of baby boomers to make room for the next generations. One interviewee stated that *"we need to tell these baby boomers to get the hell out of the way."*

- So, while interviews did state cautious optimism, we believe that, on balance, they are really quite optimistic about 2018– which, of course, can change quite quickly (as has been proven in the last week with the stock market).

As stated in the interviews, a number of firms did very well in 2017, but did not grow (in terms of people, hours, or services). In fact, the lack of growth has become the real *"elephant in the room."* All good businesses need to grow (in prior monographs, we called it the capitalistic imperative) and law firms, as good businesses, also need to grow. So, when asked about what they expect to happen in 2018, many talked about a clear refocus on an achievement of substantive growth. They also talked about analytics, continued improved profitability, better use of technology, a continued focus on profitability (beginning with holding partners accountable), better collections, improved cross-selling, and continued industry/practice group improvement.

But they came back to the need for *"growth, growth, growth,"* even though they know that the individual firms cannot really grow until the legal market (demand) does. For that reason, we heard much more of a desire to look at potentially effective mergers this year than we have in prior years.

AREAS OF EMPHASIS FOR 2018

In the context of that overall growth imperative, following are the areas that the interviewees felt they would be spending more time and effort on in 2018.

- Achieve the growth and profitability improvement desired by **focusing on managing the firm through the right industry and practice groups** (e.g. – pharmaceuticals, life-sciences, energy)

- Taking a **tough, but responsible focus on profitability** – getting the bills out quicker and following-up on the unpaid bills consistently, more rapidly, and more comprehensively; ensuring that partners are held accountable for billings and collections; eliminating unprofitable and difficult clients and, for that matter, underperforming partners (both an external and internal *"culling of the herd"*)

- **Encouraging our young entrepreneurs** to do the right things **and *"not making them jump through bureaucratic hoops and get permission to go to the bathroom."***

- Considering looking at **relationships/alliances with alternative service providers** who can do what they do cheaper and better than what law firms can.

- **Planning for, measuring, and encouraging cross-selling** – *"if you're already in the room with a client, you ought to be able to do more for them."*

- **Enhancing the Firm's business development culture** and rewarding and recognizing those who bring in good, solid, and profitable work.

- **Growing non-headquarters offices** – ensuring that **all our practices and offices achieve** critical mass or have plans to get there.

- Consider taking a page out of the plaintiffs attorneys' playbook – develop **a stronger and more effective intake system and procedures**.

It is clear that the areas of near-term emphasis in 2018 consist of pretty hard-nosed management things (as in, *"let's make more money"*). It was not that long ago that a lot of firms talked about how the next year or so was going to be a time for emphasizing *"diversity and inclusion."* That idea did receive a couple of comments this time around, but not nearly the number of comments about and emphasis on the short-term areas of hard-nosed profitability and management focus. Diversity and inclusion have not gone away – general counsel still focus on it and outside counsel selection processes and certainly in any speeches they make. But it is often hard to see where it has strategic impact above and beyond politically correct speech (which we agree is very important to some general counsel).

LONGER TERM ISSUES AND CONCERNS

Our final question, as it has been in prior years, was what the longer-term issues are that the interviewed firms and other law firms need to deal with. We heard a long, but very good, list this year – these issues and concerns follow.

- **Clients have become most firms' greatest competitors** – inhouse counsel continue to take a good bit of work in-house (often the more commodity related). It is a trend that started in the Great Recession and continues on.

- **Technology** – virtually everyone mentioned technology in some way shape or form. From artificial intelligence to block chain development to system integration with clients there was real concern relative to developing this technology, being able to afford it, and being able to compete with larger firms. It is safe to say that technology will be on the list every year that we do this – now and into the future.

- **Differentiation** – for each firm to ultimately be successful it has to differentiate itself from its competition in a way that is understood by clients and potential clients. Simply put, successful law firms have to do it better, faster, and in a more valuable way than their competition – and the clients have to know it. So, the marketing function needs to spend more time on true differentiation than cocktail parties and filling seats in skyboxes (which we believe are the largest boondoggle in a firm's marketing budget).

- **Need to keep partner income growing** – so that the best partners are not susceptible to the siren song of our competitors (although SLFC would argue that you need to keep partner income growing for your most productive and valuable partners – not for your least productive and least able partners). In fact, if firms would really focus on adequately rewarding their best and potentially best performers, they would probably get considerable bang for that buck.

- **Continuing client professional and financial pressure on outside counsel** – the clients gained considerably more power over their outside counsel in the Great Recession (2008 – 2009) and while some of the things they have done with/to outside counsel have not been productive (e.g. – required responses to RFPs and *"reverse auctions"*), the clients are clearly in the driver's seat and while they are resistant to change (remember they are also lawyers), they are clearly looking for fresh approaches and law firms that add value.

- **The practice of law must be streamlined and become more efficient** – process improvement has to be part of virtually every firm's management strategies. While it is true that most do not understand it, those that do can gain substantial benefit and true differentiation from applying it. Importantly, process improvement does not necessarily mean a computer system that monitors secretaries. Rather, it means productive changes in the way law is practiced, a real threat to the status quo.

- **Cheaper entrants to the legal market** – a number of companies have figured out that a lot of what passes for practicing law does not need to manually be done by lawyers and have designed alternative approaches to legal services that are considerably less expensive and, in some cases, just as effective. For example, the Final Four worldwide accounting firms have become strong providers of legal services internationally and they will ultimately and directly compete in the US. And, a number of clients have figured out that commodity work can be done by much cheaper attorneys or paraprofessionals than those in major law firms.

- **Continued mergers and consolidation** – according to Altman Weil, there were 102 mergers in 2017 and while many were acquisitions of small firms, a number were quite significant in size and impact (e.g. – Saul Ewing's merger with Chicago's Arnstein & Lehr and Ballard Spahr's merger with Minneapolis' Lindquist & Vennum). With technology and other expense factors, the cost of doing business is going up, and it is difficult for small or smaller law firms to compete and demonstrate the capabilities and resources desired by clients.

- **Growth will be in growing markets –** a number of very good law firms have their headquarters city or large numbers of attorneys in markets that are just not growing – the smarter law firms will focus on the growing markets rather than their former *"centers of power."*

- **Succession planning a long-term concern** – a number of the interviewees underscored the importance of successful succession planning and execution in 2017's results – there is no question that the need for effective succession planning (both for clients and internal management) will remain an important issue for years to come

- **In many firms, still quite difficult to get partners to think like owners –** this problem (which has existed for the full length of our three partners long experience in serving law firms) was still mentioned as a longer-term concern by many of the interviewees. While there is not a magic answer to it, is clear to us that ownership performance (as well as professional and financial performance) has to be part of the rewards/compensation system (*"you have to act like a partner to get paid as a partner"*).

- **Associate leverage (as a primary driver of profitability) a thing of the past** – many larger firms make and still make a good bit of their partner income off the sweat of a large number of associates – but, the trend has been going the other way and certainly technology and process improvements are changing this. Partner income probably has to become more of a function of the value provided the client and less than the financial leverage achieved by providing the service.

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- **Underperforming partners will be pushed out** – there is a fairly common belief that compensation adjustments down will serve as reasons for underperforming partners to consider leaving – we have found that that is not really the case (why would they leave, they get paid handsomely for underperforming and they will not make more elsewhere). More and more law firm managements are recognizing that they will have to be pushed out.

- Also, **the baby boomers will have to be pushed out** (both out of the way and out of a firm) – we were surprised how much the baby boomers were perceived – by our interviewees – as obstacles to progress. We have seen baby boomers strongly resist leaving both management positions and client responsibilities and become real obstacles in merger discussions (*"what's in it for me?"* or *"why should I change?"*) and in underperforming partner assessments (that is tough for us to say, because all three of us are boomers).

SLFC COMMENTS

This section summarizes Smock Law Firm Consultants' comments on what we heard. Obviously, we do not address each and every issue raised, but did want to comment on a few.

- Beneath the surface, most people were very optimistic on their firms' prospects, the legal market, and the economy. The very good results at the end of 2017 indicated that these results would continue into 2018 - and in many cases they will. And, 2018 for many could be the best year ever – but we do remember that business cycles do exist and when things are really going well, it is only getting closer and closer to a time when things will not be going not so well. We selfishly hope 2018 is very good (it sure helps our practice), but we've been through this before and feel **cautious optimism is appropriate**.

- While there are exceptions that prove the rule, litigation practices (as last year) are not doing as well as transactional practices. We believe it may very well be that this **downturn in litigation work may be a distinct long-term trend** rather than an anomaly. We did not see or hear anything to change that conclusion.

- It has not always been the case, in the years we have assessed the legal marketplace, **that larger firms have consistently done better** than smaller firms. But, that certainly was our conclusion this year, based on the interviews of both large firms and midsize firms. While the reasons probably vary by firm, our impression is that, generally, larger firms have been more serious and effective at making necessary management improvements, implementing new management tools (including robust data analyses and capabilities), and dealing with underperforming partners. It is probably true that medium-size firms need to catch up and toughen up.

- The comment that *"**the baby boomers are in the way**"* really hit us this year. We have seen baby boomers hold on to power for much too long, rather than pass it on to the next generation; not retire when they should have; and be major obstacles to management improvement and, in some cases, very good combinations/mergers. Although our three partners are all boomers, we agree that the baby boomers ought to get out of the way and let the next generation lead the way.

- As we conducted the interviews, it became apparent that a number of firms (of all sizes) have made a very important shift – **focusing their marketing resources on groups, rather than individuals**. We believe this group marketing and business development is the appropriate approach for the future and this trend is a real positive (albeit long-overdue).

- There are two human resource conclusions that are hard to avoid. It is obvious that **law firms do not need nearly as many associates as they used to**, either to do the work or maximize profitability. Secondly, many of the interviewees have seen that **underperforming service partners are taking up space** that could best be filled by others (most often confident, talented younger partners who are trying to build their practices).

- It also appears that **associates and paralegals are not as busy as they could be or should be** in many firms. There are lots of reasons (including partners hoarding the work), but the end result is a real drain on profits that could be dramatically improved if these associates and paralegals were busier than they are now.

- One of the interviewees made a particularly important point – yes, change is necessary and important, but **the pace of change is determined by clients, not their outside counsel**. The secret is still to meet client needs, but not necessarily being on the leading edge of change.

SLFC'S RECOMMENDATIONS

It is hard to generalize recommendations across the entire legal market, but a number of things were suggested in these interviews that we believe we should repeat and our readers should consider implementing – they follow.

- **Develop and execute a two-pronged growth strategy** - deal with the elephant in the room by developing a two-pronged growth strategy that includes both an active search for one or more meaningful mergers/combinations and investment and emphasis on growing a firm's competitively strong industry and practice teams (actually these two prongs do support each other).

- **Continue the trend to better management** with a focus on profitability, utilization of meaningful data to make decisions, practice and industry teams as true performance focused business units with clear rewards to those who perform.

- **Either get the associate and paralegal base busy or right size them** – those two groups must be a source for significant profit, rather than being carried at levels of productivity well below partners.

- **Get the right people running the practices and reward them** – this is usually not the rainmaker or the busiest partner, but rather the partner best suited by talent and inclination to manage the team.

- **Clearly spell out and celebrate firm culture and values** – if the three of us had a dollar for every law firm we have served that talked about their great culture, but had no definition of what it is, we would be rich – it is important to ensure that not only the culture is a good one for what you want the firm to be, but also that everyone understands it and lives by it.

- **Get rid (yes, get rid) of the long-term underperforming partners** – we say this every year and interestingly those firms that rationally, effectively, and humanely deal with this problem report two very distinct results – (1) dramatically improved financial performance and (2) better morale and commitment from the performers (particularly, younger partners and associates).

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About Smock Law Firm Consultants

Smock Law Firm Consultants is a focused strategic management consulting firm serving law firms (our primary industry concentration), other professional service firms, and commercial entities. We help law firms address and resolve those key issues that have a major impact on a firm's near-term success and its long-term direction and focus. We focus on seven key areas of practice – (1) **strategic planning** at firm and practice levels; (2) **strategic plan implementation and execution**, in essence, helping clients do what they said they would do; (3) **mergers and combinations assistance**, helping identify, negotiate and implement combinations; (4) **practice/industry team management**, helping the team concept achieve its potential; (5) **law firm economics**, helping our clients improve profitability and deal with longer term financial issues; (6) **operational excellence**, improving both the effectiveness and efficiency of firm operations (i.e. – process improvement); and (7) **strategic management issue resolution**, assisting in resolving issues of vexing management concern (e.g. – partner compensation).

We believe there are three factors that clearly set us apart.

- The primary success factor for any consulting firm are the results achieved by our clients – in both the near and longer term. Our client references speak directly to those results.

- Our *first string* and, actually, our **only** string (Smock, Giuliani, and Fiebert) is, simply, **the most experienced group of senior consultants serving the legal profession**. These three partners bring a collective relevant experience of greater than 135 years and **each** has greater than 40 years of varying but relevant experience in law and professional service firm management.

- We tailor our approach to every consulting assignment to the unique needs and requirements of the client. We are known for our **originality and creativity** in doing that and for our scrupulous avoidance of promoting *law firm management dogma.*

Again, thank you for either participating in our survey, being interviewed, or considering its results.

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"AND THE CAISSONS KEEP ROLLING ALONG, BUT SIGNIFICANT CHANGE AFOOT"
SUMMARY OF SMOCK LAW FIRM CONSULTANTS' ANNUAL LEGAL MARKETPLACE ASSESSMENT

How Did It Go in 2017?

- Over 80% hit their budget or did better (some, a heckuva lot better)
- Generally, larger firms did better than smaller firms
- Revenue ranged from slight drops to dramatic increases
- Last half of the year very strong *"off the chart"* increases
- Very good results in the transactions practices *"beyond our expectations"* – litigation problems continued
- Dollars were generally up – but, charged hours trending down (a continuing pattern)
- Most rate increases held (2% at low end to about 5% at high end)
- Firms believed that they are generally managing their businesses more effectively – focused on profitability, good use of data, and smart pricing
- Because of strong 4th quarter results, most very bullish on near term future

Expectations for 2018?

- While many said *"cautious optimism,"* most more positive on near term future than that
- In truth, 2018 should be pretty good – continued strength in transactions, healthy rate increases, and effective financial management continuing
- Overall improvement in individual practice financial management bodes well for future
- Some negatives out there – the continued pressure from general counsel, the litigation dilemma (will it come back?), underperforming partners, and baby boomers blocking progress
- Elephant in the room – overall growth not occurring – yes, revenue and profits have gone up, but because of better financial management and rate increases, not from real growth

Areas of Management Focus

2017

- Rate increases
- Focus on profitability (across the board)
- Effective use of management data
- Successfully dealing with succession
- Underperforming partners
- Practice group management effectiveness
- Improved technology and cyber security effectiveness
- Improved space utilization
- Improved marketing/business development effectiveness
- Focus on specific industries and market areas
- Focus on diversity and inclusion
- Continuing improvements in client relationships

2018

- Certainly all of the above factors
- Managing the firm through the right industry and practice groups
- Tougher, but responsible, continuing focus on profitability
- Encouraging young entrepreneurs
- Relationships/alliances with alternative service providers
- Planning for, measuring, and encouraging cross-selling
- Enhancing a business development culture
- Growing the non-headquarters offices to critical mass
- Stronger and more effective intake

Longer Term Issues and Concerns

- Clients have become firms' most significant competitors
- Technology, technology, technology
- Differentiation
- Need to keep partner income growing
- Continuing client professional and financial pressure on outside counsel
- A streamlined and more efficient practice of law on horizon
- Cheaper entrants in the legal market
- Continued law firm mergers and consolidation
- Growth coming from geographic growth markets
- Getting partners to think and act like owners
- Associate leverage a thing of the past
- Underperforming partners need to be pushed out
- And, the baby boomers need to be pushed out too (or, at least, out of the way)

SLFC Comments

- People generally very optimistic (they have to say *"cautious"* – but, caution appropriate)
- Downturn in litigation work more than likely a long term trend and here to stay
- No question this year that larger firms did better – why? – probably better management and/or effective differentiation
- *"Baby boomers in the way"* also probably quite true
- Good to see a clear refocus of marketing resources on groups/ teams, rather than individuals
- Law firms appear to not need nearly as many associates as they used to
- Associates and paralegals are not nearly as busy as they should be
- The pace of change is determined by clients, not their outside counsel

SLFC Recommendations

- Develop and execute a two-pronged growth strategy – one or more meaningful combinations **and** a focus on the best teams/industry groups
- Continue the definite trend to better practice and firm management – expect and ensure performance
- Either get the associate and paralegal base busy – or right size them
- Get the right people running the practices **and** reward them
- Clearly spell out (so everyone understands) firm culture and values
- Get rid (yes, get rid) of long term underperforming partners

2/8/18

SMOCK LAW FIRM CONSULTANTS