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Profiting from efficiencies in a digitally disrupted world (Part 2)

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Having previously discussed the need for a principle-based approach to changes in the business model, in this article we explore the implications of a digitally leveraged model on profitability for business law firms. Specifically, we quantify on a fully costed basis the increased profitability of firms that are not only able to invest in and adopt digital solutions but are also able to re-shape their resourcing mix to reflect a new operating paradigm. In doing so, we aim to at least partially answer the two-headed question that frequently exercises managing partners: "How much more profitable can our firm be and how much more profitable do we need to be to compete effectively?"

In envisaging scenarios in which much of the work that is done by lawyers today will be subject to automation in the future, managing partners will need to consider the impact on financial performance of moving from a people-leveraged to a digitally leveraged model. This is fundamental in seeking to build an aligned business model and enabling structures.

Standardisation versus commoditisation

Automation inevitably heralds greater efficiency, which in a low to no-growth scenario will mean fewer lawyers. However, the starting point should not be rationalisation per se but rather a critical review of processes to ensure that the value of services (both to clients and the firm) is protected. Even before realising the potential that digitisation has to enhance legal services including in responding to hitherto unimagined needs, firms have yet to fully appreciate benefits of standardisation in the work that is already done.

Our experience is that even in well-established, market-leading practices, a high degree of variation remains in service execution and delivery. In any business, deviation from a standard process (where this is achievable) erodes profit and creates opportunities for others to capture market share.

Furthermore, first movers and early adopters can capitalise on the opportunity cost of unleashing capability to grow their market share of higher value and emerging areas in what might otherwise be flat market conditions.

Cost accounting... but not as we know it

In our earlier article, we re-stated the importance of the cost multiple (the ratio between the revenue generated and the direct costs of the fee earners who generated it) as a critical metric in managing profitability. Used properly, this is more than an accounting device and can be a highly effective tool in a) managing performance, and b) building an adaptive business model that is 'fit-for-purpose'. We also stated that in:

- A traditionally leveraged higher value professional services model, a cost multiple of three times is generally considered competitive in most markets and for most types of higher value work; and,

- A digitally transformed profession, this figure will increase depending on the extent to which tasks previously carried out by fee earners are subject to automation over time (including the replacement costs of technology).

This is evidenced in the analysis in Tables 1 and 2.

However, even amongst firms who recognise its merits, the cost multiple is rarely used consistently. Disagreements about cost allocation, in particular assigning a notional salary to equity partners, tend to limit its more widespread application. (As a yardstick, an equity partner notional salary should be quantified based on the highest paid employee plus a percentage and should be comparable with General Counsel packages amongst a firm's core clients.)

Whilst these disagreements will persist, it is increasingly critical that financial performance be measured on a fully costed basis, not least in helping to assess a firm's ability to invest in process refinements including capital costs.

For the purposes of our analysis, we have:

- focused on the Legal Business Global 100 firms, specifically the 83 firms[1] that have appeared in each of the last five years' annual rankings;

- assumed a proportion of total costs (in this case 33%) is accounted for by non-equity lawyers' direct costs i.e. salary and related package; and,

- allocated a notional salary for equity partners of firms that sit within bands on a sliding PEP scale in 2018.

Commonality In diversity

We recognise that among the Global 100 firms, there is a range of practice, core client, and market focus that translates to varying business models and leverage structures, and ultimately financial performance. Whilst clearly no one size fits all, each of these firms is business law in nature, albeit with differing degrees of focus. Hence, it is reasonable to assume that the vast majority if not all (regardless of the level of investment and restructuring to-date) can profit from greater efficiency.

In 2017/18, the reported total revenue from the sample group was US$94 billion (an average revenue of US$1.13 billion per firm and US$4.62 million revenue per equity partner (RPEP)). The average margin was 41% and average profit per equity partner (PEP) was US$1.88 million.

Table 1: Global 100 – Average Firm Financial Performance (2018)

Type	Total revenues (US$m)	Net income (US$m)	Margin (%)	RPL (US$k)	CPL (US$k)	PPL (US$k)	Leverage	RPEP (US$k)	PEP (US$k)	PEP (US$k)	EPs (#)	Cost multiple
Reported	1,128	459	41%	871	517	354	4.3	4,622	1,879	244	1,295	n/a
Fully costed	1,128	362	32%	871	592	280	4.3	4,622	1,483	244	1,295	3.6

Source: Legal Business Global 100. Analysis: Cambridge Strategy Group

Applying the equity partner notional salary and all other things remaining equal:

1. There is a nine percentage point difference in average margin between the reported profitability of the Global 100 and the same firms on a fully-costed basis in 2018 (41% cf 32%).

2. Profit per lawyer (PPL) is 21% lower at ~US$280,000 cf ~US$354,000 and, hence, PEP is also 21% lower at US$1.48 million cf US$1.88 million.

At 3.6, the cost multiple is at or above a competitive level for traditionally leveraged firms focused on higher value work, consistent with the market positions of most of the firms in the Global 100.

1 - Dentons and King & Wood Mallesons also appeared in each of the last five years. However, in both cases their financials are not fully disclosed.

The urgency with which firms seek to adopt change should be higher for those a) who are focused on lower value work or b) whose market share of higher value work is more limited. However, in principle all firms should take a similar approach.

It's All About The Base...Isn't It?

Whilst the impact of disruptive technology on the traditional people-leveraged model has yet to materialise across the market as a whole, we expect there to be a significant shift within the next two to three years. We will then see an acceleration as firms begin to realise efficiencies including through enhanced machine learning. As this happens, it is reasonable to assume that the ratio of non-equity lawyers to equity partners will decline in the medium term. As technology is able to complete tasks previously carried out by lawyers, lawyer numbers will decline.

The degree to which firms are able to reduce headcount and associated costs will depend on three factors: the nature of their focus and, therefore, the degree to which lawyer-intensive tasks can be performed by technology; the extent to which they have invested in and adopted non-lawyer solutions including technology; and the degree to which they are already established within a market or markets.

For the purposes of our analysis, we have assessed the impact of five percent decreases in non-equity lawyer headcount to up to twenty-five percent including commensurate reductions in direct costs and partial reductions in indirect costs.

What does this mean for us?

Whilst one can debate the accuracy of the allocated equity partner notional salary and the proportion of direct and indirect costs associated with non-equity lawyers, as well as the degree to which headcount reductions are feasible and by what percentage, this would detract from the overriding issues, namely that:

- pressure is increasing on a large number of firms to invest more heavily in process improvements including capital investment in technology

Table 2: Global 100 – Average Firm Financial Performance: Fully Costed (2018)

Non-equity lawyers (#)	Total revenues (US$m)	Net income (US$m)	Margin (%)	RPL (US$k)	CPL (US$k)	PPL (US$k)	Leverage	RPEP (US$k)	PEP (US$k)	EPs (#)	Total laywers (#)	Cost multiple
-25%	1,128	473	42%	1,093	634	459	3.2	4,622	1,939	244	1,032	4.3
-20%	1,128	451	40%	1,040	624	416	3.4	4,622	1,848	244	1,085	4.1
-15%	1,128	429	38%	992	615	377	3.7	4,622	1,757	244	1,137	4.0
-10%	1,128	407	36%	948	607	342	3.9	4,622	1,666	244	1,190	3.8
-5%	1,128	384	34%	908	599	309	4.1	4,622	1,547	244	1,242	3.7
100%	1,128	362	32%	871	592	280	4.3	4,622	1,483	244	1,295	3.6

Source: Legal Business Global 100. Analysis: Cambridge Strategy Group

On a fully costed basis, a 25% decrease in non-equity lawyer numbers equates to:

1. A 20% decrease in average total lawyer numbers from 1,295 to 1,032 and, hence, a 25% decrease in average leverage from 4.3 to 3.2, plus a 25% increase in average revenue per lawyer (RPL) from ~US$871,000 to US$1.09 million.

2. A 64% increase in average PPL from ~US$280,000 to ~U$459,000, hence a 31% increase in average PEP from US$1.48 million to US$1.94 million, plus a 31% increase in average margin from 32% to 42%.

3. A 21% increase in the average cost multiple from 3.6 to 4.3.

In 2017/18, 47% of the sample firms (37 out of 83) generated revenues in excess of US$1 billion. Approximately the same number reported average RPL in excess of US$1 million. Fewer (25) generated PPL in excess of US$400 k on a fully costed basis and only 21 generated PEP in excess of US$2 million cf 38 based on reported financials. As with the mean, the median cost multiple is 3.6, with 37 firms registering a cost multiple equal to or in excess of 3.5.

Table 3: Global 100 – Average Firm Financial Performance (2018)

Non-equity lawyers (#)	Firms with > US$1bn rev (#)	Firms with > US$2mn PEP (#)	Firms with > US$1mn RPL (#)	Firms with > US$400k RPL (#)	Cost multiple	
					≥ 3.5	≥ 4.0
-25%	37	41	53	49	82	64
-20%	37	36	47	43	82	42
-15%	37	34	44	40	82	30
-10%	37	28	44	33	68	21
-5%	37	21	41	29	51	18
100%	37	21	38	25	37	13

Source: Legal Business Global 100. Analysis: Cambridge Strategy Group

On a fully costed basis, a 25% decrease in non-equity lawyer numbers equates to:

1. Nearly two-thirds of the sample firms registering RPL in excess of US$1 million
2. Nearly 60% of firms registering PPL in excess of US$400,000 and nearly half of the sample firms registering PEP in excess of US$2 million, approximately double the number of firms at current resourcing levels.
3. Virtually all firms with a cost multiple in excess of 3.5 and over three-quarters in excess of 4.0, five times as many at current resourcing levels.

- the reported financials of many of these firms flatter to deceive, hence, a more realistic approach is required using a fully costed method that represents the true 'cost of production'
- as much as firms have profited in recent years from reducing costs by moving work to lower cost centres and protecting PEP by pushing out leverage, these tactics are not sustainable
- hence, more fundamental changes are required to support longer term competitive positions.

We do not underestimate the complexity and sensitivity associated with changes in the resourcing mix nor the fact that every firm faces unique challenges within its markets. However, intensifying competition in every market driven by client demand is likely to make this a necessity rather than a luxury in the foreseeable future.

These are considerations for managing partners and rank-and-file partners alike. It is incumbent on all equity partners as shareholders to critically appraise the nature and structure of their practices in the context of the firm's strategy and in view of changes in their operating environment.

To the questions we posed previously to which law firm leaders will increasingly need to respond, we add the following:

1. On a fully costed basis, how many of our current practices/worktypes are already unprofitable and how many will become unprofitable within the next three years?

2. What needs to change in order to increase the profitability of these practices/worktypes to a competitive level?

3. How will we fund the required investment?

4. In addition to changes in our non-equity resourcing mix, does our current equity structure reflect our future business needs and model?

5. How should we manage the talent pipeline in light of changes in the resourcing mix?

6. How should expected contributions change (quantum and balance)?

7. What changes should we make to our performance management processes to measure these?

If these and those previously posed are questions that you are already considering but not fully able to answer or questions that you are prompted to ask, please contact us.

This article is the second of a series of two. The first may be found and downloaded at:

http://www.camstrategy.com/2018/08/03/managing-profitability-digitally-disrupted-world/

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