

THE Hoffman Alvary SURVEY™ 2010

ON LAW FIRM ECONOMICS

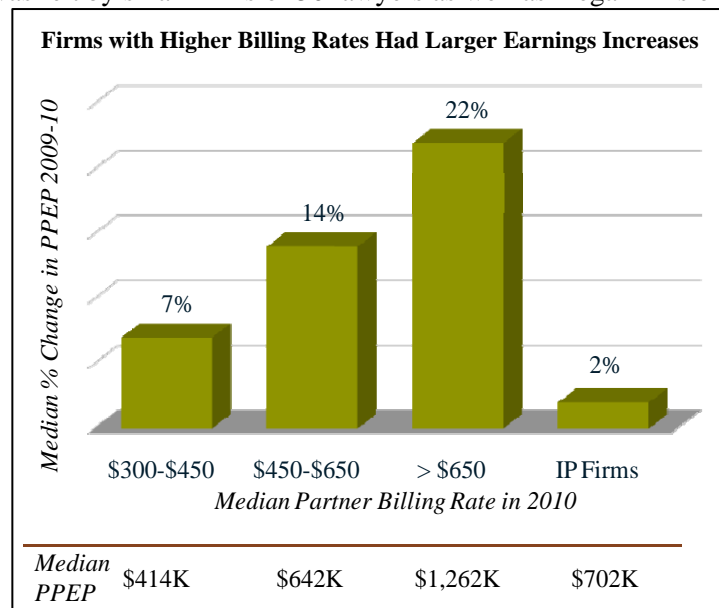
Managing Partner Advisory Law Firms Profit in 2010 and 2011: The Widening Gap April 2011

Law firm financial results for 2010 varied tremendously. It was a remarkable year for many firms as they experienced a real and sustained recovery – an embarrassment of riches. For others, it was a continuing struggle to weather a prolonged downturn. For most capital market firms, the recession began in Q4 of 2007 and ended with a robust Q4 in 2010; for most mid-market firms, the downturn hit much later in the business cycle, even as late as mid-2009, and the recovery has not yet been felt. Within this enormous range of experiences and underlying causes, we have observed some themes and cautionary observations that apply broadly across many firms. Some who are prospering have merely been lucky; others have taken heed of the market's serious changes with insight and skilled execution.

The Recovery Is Underway, But Its Effects Are Tremendously Uneven

Market demand has returned more quickly for high-priced, high-value work than it has for commodity-priced legal services. For firms that were either fortunate or well-positioned, a strong volume of high-end transactional or litigation work, coupled with a high margin on that work, combined to create a power surge in 2010 partner earnings. This effect was felt by small firms of 50 lawyers as well as mega-firms of over 1,000 lawyers.

Just consider the relationship between partner billing rates and earnings increases in 2010. Firms with median partner billing rates over \$650 saw a 22% median increase in profits per equity partner. Firms whose more modest median partner rates ranged from \$450 to \$650 enjoyed a better year than in 2009, but with a significantly smaller 14% increase. Partnerships, both large and small, with median partner rates between \$300 and \$450 showed the smallest gains, at only 7%.



These insights are based on a very broad view of the legal market; in the Hoffman Alvary Survey on Law Firm Economics and in our consulting practice, we advise firms encompassing 25,000 lawyers and 40 million billable hours.

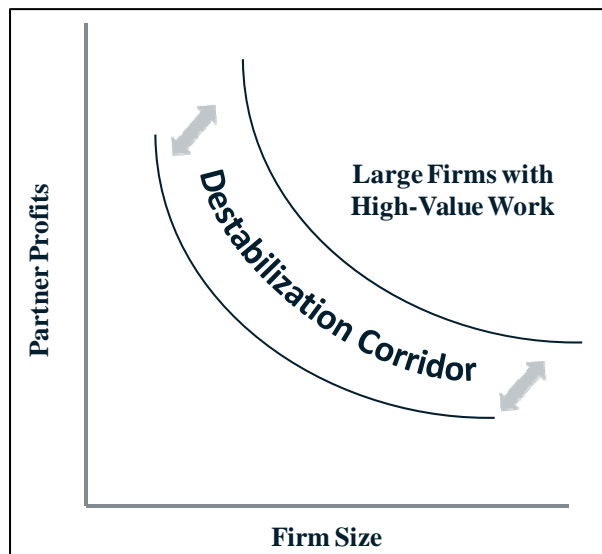
This result dramatically amplifies the gap between the highest earning firms and those with middle-market earnings and practices. The firms with the highest median partner rates and the largest earnings increases were already doing well: these are the same firms whose 2009 earnings already outstripped by two-to-one those of firms with mid-market partner rates.

The Disparate Recovery Is Profoundly Destabilizing

This widening earnings gap separating cadres of firms puts a real strain on firms with disappointing earnings. We anticipate that several major firms will be shaken in the near-term, and some will unfortunately suffer a fate similar to Howrey.

Ironically, firms with a consistently middle-market practice may not feel the destabilizing effects of the uneven recovery. The destabilizing effect is most pronounced in firms that aggregate some high-rate, high-value work with other, more middle-market practices. As these “composite” law firms approach their own long-held aspirational earnings targets, they may find themselves in a definitional quandary, with better earnings putting them at risk.

Many may ask why this odd result should ensue. After all, improved earnings should strengthen a firm, even if those earnings come from an up-market move affecting only selected niche areas. The answer is that firms with inconsistent earnings platforms face “flight risks” from partners in high-end practices, and this risk is material enough that it may well bring down some firms in 2011. Paradoxically, a more homogeneous practice mix at modest earnings levels can be more stable: a widely shared commitment to higher-end, or even middle-market, practices makes positioning choices more consistent and effective.



Certain firms in this destabilization corridor need to decide how best to position themselves despite their highly mixed services and clientele. Because their partners operate in dissimilar markets, these firms struggle with many key practice decisions such as starting salaries, client intake standards, billing rates, lateral candidate assessments, and associate advancement standards. Further economic recovery will improve productivity and cash flow, but will not inherently meld disparate groups within firms that would benefit from more consistency in both their positioning and their earnings expectations. Beyond dealing with the enormous changes in the market, the task of positioning and running an eclectic practice mix may present many managing partners with their most significant challenges.

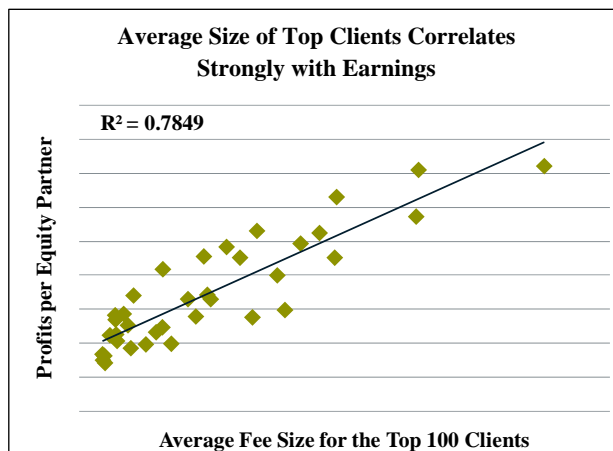
The 2010 Earnings Increases Rested on a Broad Demand Uptick from an Array of Large Clients

In 2009, many firms posted strong results due partly to personnel and expense cuts, but a limited number of firms also had spectacular fee increases from their top 10 clients. These few, but seminal, client

engagements generally involved litigation stemming from the financial crisis. The earnings impact of these marquee engagements was dramatic for only about two dozen major firms – a small, but significant, group which enjoyed an idiosyncratic outcome relative to the market as a whole.

In 2010, firms with the greatest earnings rebound achieved their results based on total fee increases for their top 100 clients, validating the general impressions of a wider, more stable recovery. At large firms, the correlation between changes in partner earnings and revenue from the top 100 clients is remarkably strong.

In fact, this relationship is twice as high as the correlation between changes in earnings and revenues in the top 10 clients.



The Past Several Years Have Been About Price; The Next Several Should Be About Process

Most partners have become all too familiar with deepening discounts and alternative fee agreements (AFAs) that are often intended by clients to predict or reduce prices. The more interesting AFAs include risk corridors, fixed fees by phase, discounts with success fees, and other variants that shift risk and opportunity to the law firm. In our view, a return to higher volumes of business activity and legal work will not stem the growing popularity of these pricing controls among clients.

There may be long-term folly, however, in studying the pricing alternatives for legal matters without concurrent scrutiny of the work processes themselves. The market in 2011 and beyond will require practitioners to rethink how they conduct their matters, and new uses of technology, innovative staffing models, and updated training and development of personnel will all take center stage. Until now, changes in these areas have too often been initiated only by firmwide budgeting processes. Going forward, this result should be inverted: as clients pressure partners to drive costs down, it is time for the firmwide outcome to reflect the aggregate of matter by matter process and personnel changes designed to improve efficiency. This means that practice group leaders need to take charge of redefining (or reconfirming) tasks for effectiveness and efficiency appropriate to both the risk and also the value of the work to the clients.

Several Distinct Types of Post-Recession Merger Discussions Are Underway

Most major firms have taken serious notice of the Hogan Lovells and SNR Denton combinations as these firms seek to cement their international capabilities among increasingly global providers. Many similar discussions are underway again after the near hiatus during the deepest months of the recession. At the top of the market, potential transnational combinations have largely displaced discussions between pairs of very large US firms.

Even as more large firms are investigating their tolerance for truly global and transformative events, regional US and national firms have begun to underwrite their own access to international markets through smaller off-shore acquisitions. For some firms, this has been very effective in attracting and

sustaining top clients; for others, the relevance of international capabilities to most of their US partners is still elusive. Unconvinced partners at these regional US firms may be less than willing to support the typical five-year cash demand for fledgling overseas offices.

On the domestic front, regional US and national firms are seeking to expand their US footprints by acquiring small firms at a new pace and with a new level of vigor. While most large firms enthusiastically seek laterals, they recognize that adding ones-and-twos generally does not change their position relative to other firms. As a consequence, the post-recession appetite to consider firms of 20 to 150 attorneys has produced a near seller's market for the targets. Most firms with fewer than 40 lawyers present ownership issues and professional positioning that make combining with a larger firm challenging.

Fewer firms exist in the 50 to 150 lawyer size, but they are structurally much more compatible with their potential acquirors. We expect to see many of these combinations in 2011 and 2012 as sought-after firms in this size range respond with more interest than in the past. Many smaller firms are aching from the effects of the post-recession gaps in earnings, market share and client access. As a result, some of these target firms have reconsidered their historical postures of refusing to entertain merger offers. In addition, other firms that have weathered the recession quite well may nevertheless choose to reevaluate the risk/reward profile of remaining standalone and competing with firms that have more cash, more expertise and greater access to a broad range of clients. Firms that were once staunchly against mergers are now entertaining calls from potential combination partners and at least considering a merger as a viable strategic option.

Some firms, even a few very large ones, face serious first-generation issues with an aging demographic bubble headed toward retirement. Not only were the good old days of the 1990s a different economic and client era, they also saw many firms with their strongest partners then in their late '40s. These partners are now the subject of transition concerns, including angst over the next generation's ability to develop marquee stature and long-term client loyalty, looming post-practice retirement payments, and many other less obvious challenges. If the next generation of partners is unlikely to develop in time to transition clientele effectively from current firm leaders, a merger can represent the best continuity plan for the enterprise. As the baby-boomer bulge approaches retirement, this demographic issue will reach a head in many more firms.

Assessing the Strength of Your Strategic Platform:

- ❖ Are your current partners in their 40's stronger than the older partners were at the same age?
- ❖ When comparing your firm's top 100 clients today and five years ago, is the quality of clientele and assignments improving or deteriorating?
- ❖ What is the caliber of your firm's new clients? Are the new clients likely to become key, sustaining clients on par with those from prior eras?
- ❖ Could your firm re-win its best clients today on the open market, or are they legacy relationships from a bygone era?

The Current Lateral Market Has a Distinct Character

Lateral activity in late 2010 and early 2011 has picked up to dramatic levels. During the recession, many potential laterals were reticent either to uproot their precarious clients or to satisfy themselves that their suitor firms offered long-term, safe havens. This year's lateral frenzy is profoundly different from the typical post-recession mobility in one important regard: unlike in years past, many recent laterals held key management positions at their prior firms.

It was once thought difficult to dislodge department chairs, office managing partners and practice group leaders, not to mention executive committee members. The market presumed that positions of power implied a strong fiduciary obligation tying partners to their existing firms; this resulted in few offers – and fewer acceptances – involving partners holding management titles. In fact, appointing a partner with a wandering eye to a key management position was once considered a good way to reduce the risk that they might depart. This tactic may no longer work; in fact, it may only increase the adverse impact of a departure. Today, as these leaders move, they frequently take large groups or entire practice teams with them. And when management loosens its ties to a firm, it can hardly be surprising that others increasingly regard their career options as unhindered by loyalty.

Considerations in Reviewing a Partner Compensation System:

- ❖ Are your compensation outcomes market competitive?
- ❖ Are your top performers paid for the qualities and actions that the firm wants to foster? Would aspiring partners agree with your assessment?
- ❖ If teamwork is important, how is it reflected in your firm's client credit system?
- ❖ Is your firm fostering the development of deep expertise or of generalists?
- ❖ Would your savviest clients reward the same attributes in their outside counsel that your compensation system values?
- ❖ Is changing the compensation system a red herring when other issues are the root concern?

Partner Compensation Systems Are Under Pressure

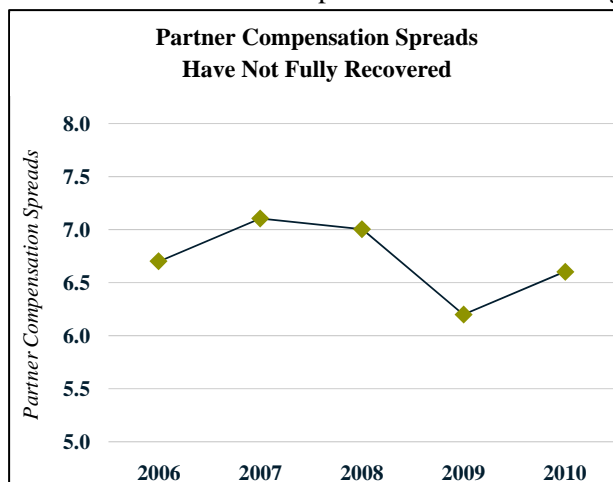
Compensation decisions are generally challenging, although for different reasons, in both bad and particularly good years. In 2011, increased lateral activity has added to the considerable pressure on partner compensation. Firms need to ensure that partners whose marketability is most obvious are satisfied with their current compensation without encouraging others to suggest their own marketability and flight risk potential. This can be particularly challenging in firms that have not yet experienced the recovery and that just weathered their third year in a row of flat or declining average earnings.

In addition, many large firms are now focusing more on incentivizing teamwork. The compensation systems need to preserve individual initiative while incentivizing more frequent collaboration. Doing so offers more than the obvious benefits of moving up market, strengthening client relationships and improving earnings; it also offers the very real ancillary benefit of tying partners more tightly to the enterprise.

Added to the variability in earnings results, the range in income allocations – a.k.a. spread – among equity partners has also risen, with further pent-up movement likely. Median spreads rose to 7.0 in 2008 because higher average earnings permitted expansion at the top without a penalty for those in the middle and bottom. Then spreads contracted (to 6.2:1) in 2009, when top performers' practices typically contracted. Last year, spreads increased

somewhat (to 6.6:1) commensurate with the nascent recovery and increased acquisitiveness of other firms, and we predict further movement in this direction as earnings increase going forward¹.

As spreads in 2011 and 2012 return to pre-recession ranges, this will further pressure firms to consider how well their own compensation systems address both internal and market pressures for their strong performers. Moderate-earning firms concerned they may be paying below market compensation to their strongest contributors typically widen their spread to be protective. This approach works so long as the market is stationary. However the market continues to move driven by firms with multi-year earnings increases, some of whom have adopted the largest increases in spread. These fortunate firms can both preserve market - reasonable compensation for mid-level contributors and also provide extra earnings for their very best.



Competition Has Returned to Associate Hiring

Several recent actions by major firms reflect new stirrings in markets once again looking to hire associates. Many national firms chose to distribute springtime bonuses in 2011. This monetary acknowledgement of associate contributions may reflect the need for better optics in light of dramatically increased partner earnings after so many associate layoffs. It is also a direct recognition of the impending marketability of well-trained, midlevel associates after several years of nearly zero mobility. This trend is echoed by the movement to return to \$160K starting salaries in some cusp cities that during the recession included two groups of AmLaw 100 firms: those offering \$145K and those offering \$160K.

Expense Reductions Helped Firms Salvage Earnings During the Worst of the Recession, But Will Look Different in the Future

2010 earnings were buoyed by the full-year benefit of expense cuts undertaken in 2009. Before the recession, overhead expense reductions were past due in most firms, but no firm can achieve a sustained recovery from the poor economy by expense management alone.

For most firms, easy expense tightening is long over. There is little room left to continue to do things the same way, but more cheaply. In many cases, significant further expense reductions will be possible only by wholesale reexamination of long-established practices. For example, relocating back-office operations to cheaper locations (within the same market or to completely different cities) is now being considered at many firms. Even if relocating functional areas is not realistic for many firms, those that bring new ideas and rethink current operations will prosper in this new cycle.

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¹Even among firms with historically wide income spreads, the same pattern holds true: their 2010 spread of 11.4 reflects real recovery from 10.1 in 2009, but not a full return to the 13.6 in effect in 2008.

Changes in fortune for some are nothing new. The profession has long been stratified between capital market cities and brick-and-mortar cities and across firms within each city. The firms with best *esprit de corps* and sustained capability are those that embrace consistent professional goals and present a consistent face to the market. While this is not a practical goal for many firms, it is nonetheless vital for partners to take pride in the same things about their own firm. And while bringing in new work is always a significant goal, firms need to look beyond the purely economic benefits of cross-selling efforts. In addition to boosting revenues, these deepening client relationships can be used as a platform for encouraging intellectual curiosity and new modes of practice that will create better ways to conduct matters. When this occurs, working together will be almost a by-product of open, intellectual thinking about what clients need and how their firm can ensure its ability to provide it. As always, improved earnings are not the cause, but rather the result, of this thinking.

Hoffman Alvary's law firm consulting practice provides a broad range of strategic and management consulting services to law firms prominent nationally and in their local markets. Drawing on a client base comprising scores of firms and more than 25,000 lawyers, our professionals bring years of experience and an in-depth knowledge of the issues facing law firm management in today's challenging environment.



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