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The 2010 Am Law 100 Gradual Recovery Signals Need for Continued Caution

Am Law 100 Financial Results for 2009¹

Profits Per Equity Partner Change from prior year (PPEP)	Gross Revenue Change from prior year (GR)	2007-2009 Average Compounded Annual Growth Rate of PPEP ² (CAGR)
0.3 % (vs. -4.3% in 2008)	-3.4 % (vs. +4.1% in 2008)	-1.7 %

Industry pundits had forecast a bleak scenario for law firms in 2009, and while the financial performance of the Am Law 100 recently released by *The American Lawyer* was slightly better than predicted, law firms should remain cautious throughout 2010. Although the economy is improving, uncertainties about the strength of key sectors, including the euro zone, financial markets, and home sales, remain, and there are concerns that large deficits will fuel inflation. These and other open questions have led leading economists to predict that full recovery will not come until late 2011 or early 2012. We advise law firm leaders to be cautious about growth, to continue to be alert to the possibility of additional, prudent cost-cutting, to reassess their associate and partner promotion models, and to invest in positioning and branding to enhance their visibility in their most profitable markets. We believe that firms that align their strategies with the current needs of the marketplace will be positioned to emerge from the recession as strong market leaders.

Am Law 100 CAGR of PPEP (2007-2009) by Region

National	-2.0%
New York	-4.1%
Midwest	1.6%
International	-1.8%
Northeast	-1.4%
California	-1.9%
Washington, D.C.	4.4%
Southeast	-0.5%
Texas	3.9%

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¹ PPEP and GR figures in this table were published by *The American Lawyer* in 2009 and 2010.

² Using data published by *The American Lawyer*, we calculated the 2007 to 2009 average compounded annual growth rate ("CAGR") for profits per equity partner for the Am Law 100 as a group, as well as for sub-groups defined by geographic location. *The American Lawyer* labels some firms as "national" or "international." It identifies the remaining firms by their city of origin. In our analysis, we used *The American Lawyer* designations and created additional groups: "Southeast" – including firms based in Atlanta and Richmond (5 firms); "Northeast" – Boston and Philadelphia (8 firms); and "Midwest" – Chicago, Kansas City, Milwaukee, Minneapolis, and St. Louis (8 firms). We also analyzed the aggregate performance of firms located in New York (19 firms), Washington, D.C. (8 firms), Texas (6 firms), and California (6 firms).

Our purpose in this *ZG Alert* is twofold: first, to offer our view of what the 2009 Am Law 100 financial results reveal about the firms that are emerging from the recession as “winners;” and, second, to offer suggestions we believe can help firms benefit from opportunities and minimize potential missteps and losses.

LESSONS FROM 2009: The Drivers of Success

- ▶ First and foremost, the slight increase in profits per equity partner (“PPEP”) in 2009 over 2008 suggests that the deep cost cutting in 2009—such as the reductions in headcount and the deferral of first-year associate start dates—paid off, yielding better-than-expected profitability in spite of the decline in gross revenues.
- ▶ In examining these results, *The American Lawyer* noted that the 23 Am Law 100 firms headquartered in New York, on average, outperformed the rest of the industry in 2009³, and we have heard this referred to as a “flight to quality.” We believe, however, that the year is better understood as reflecting a “flight to brand.” Traditionally, the New York firms have enjoyed a reputation for having the expertise to handle the largest, most complex, cutting-edge or bet-the-company matters, and have built that into a brand. And while that brand remains strong, we think another powerful brand emerged during the downturn—one that spoke of the ability to deliver high-quality work, on matters that didn’t rise to the bet-the-company level, at fee levels lower than those charged by the Am Law 100 firms. When we analyzed the 2009 financial results of 23 “second hundred” law firms that had reported through May 1, we found that these firms outperformed the Am Law 100. Among the 23 firms, PPEP grew 5.8 percent in 2009 over 2008; but more importantly, their gross revenue remained essentially flat from one year to the next, in contrast with the Am Law 100’s decline in revenue in 2009. We will reexamine this observation when the remaining “second hundred” firms have reported, but we expect to see that in a marketplace which remained cost-sensitive for non-bet-the-company matters, clients moved some work to “second hundred” firms that had successfully branded themselves as providing high-quality work on a more cost-effective basis. As we wrote in our March 2010 *ZG Alert*, in which we discussed the Am Law 100 results reported through March 1, we believe this

trend will extend into 2010, but will taper off as the economy strengthens.

- ▶ Our analysis of the Am Law 100’s PPEP, GR, and 2007 to 2009 profitability CAGR suggests that “international” and “national” firms, as well as firms based in California and New York, suffered, on average, larger declines in profits in the last three years than the other Am Law 100 firms. At the other end of the spectrum were Washington, D.C. and Texas-based firms, which saw their profits, on average, grow more during the same period. However, we do not believe that the fact that a firm is indigenous to a region can by itself predict a firm’s financial performance. Firms that did well last year most likely had a diverse client mix, the right leverage, and a rate structure that maximized revenue while meeting clients’ needs for cost reduction and increased predictability. International firms tend to be highly leveraged, which probably contributed to their relatively weak financial performance. We predict that going forward, each of the above factors—more than geography alone—will continue to play an important role in determining which firms emerge from the recession as winners.

Having said that, we recognize that some types of client matters proliferate in particular locations, so while a firm’s geographic roots are no guarantee of performance, its strength and market share in strategic locations can help predict future success. For example, sector growth is related to, though not exclusively driven by, geography: industries cluster around their requisite workforce, with manufacturing sectors predominating in inexpensive labor markets, while the technology (broadly defined to include hardware, software, and bio-science) and service sectors congregate in areas with a highly educated, white collar employee pool. It is not surprising then that Texas firms did well, given the strength of the energy sector, or that Washington, D.C.-based firms likely benefited from strong demand for their regulatory practices.

WHAT LIES AHEAD

Some Signs of an Improving Landscape

While some of the law firm leaders with whom we have spoken are predicting drops in gross revenue of up to 10 percent in 2010, most are projecting little or no change in gross revenue. However, we see a better year shaping up with each passing month of 2010, and we hear that firms are increasingly busy with corporate matters,

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³ Eric Press and Greg Mulligan, “Lessons of The Am Law 100,” *The American Lawyer*, May 2010, available at http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1202448340864&Lessons_of_The_Am_Law_&hblogin=1.

particularly M&A. Thomson Reuters' "global reviews for mergers and acquisitions" for the first quarter of 2010 showed a 20.5 percent increase in the value of worldwide M&A activity over the first quarter of 2009. The Q1 2010 results correspond to a 5 percent drop from the last quarter of 2009, but experts have voiced optimism for 2010.⁴ We also find it noteworthy that some firms are accelerating the start dates of their deferred 2009 associates, a decision that appears to signal that firms are becoming busier. However, even as the amount of work continues to rise modestly, law firms will boost their gross revenue in 2010 only if they increase productivity and improve utilization, in light of the reality that significant rate increases are unlikely this year.

A Hyperactive Market Points to Further Consolidation

The law firm merger market is entering a state of hyperactivity, prompted by inexorable pressure on firms to grow their top line in a marketplace that is resisting rate increases. More aggressively than ever before, firms are pursuing group acquisitions and mergers as part of their strategy to remain competitive. We note, for example, that on the heels of the Hogan & Hartson merger with Lovells, it has been reported widely in recent days that SJ Berwin explored a combination with Orrick Herrington & Sutcliffe and is now in discussion with Proskauer. Several law firm leaders who are considering mergers have shared with us that their strategy is to grow revenue by adding depth in their firm's core markets (broadly defined to include practice areas, geographies, and industry sectors), in order to strengthen their "top-of-mind status" in the marketplace. While we recognize the importance of focused additions to a firm's breadth and depth, we urge firms to remain strategic in their aspirations and cautious in their actions, and to refrain from pursuing growth for growth's sake. Perhaps more than ever before, firms exploring group acquisitions or mergers need to place great emphasis on vetting the members of the target group or firm.

Cost-Cutting Must Continue

Firms that took aggressive cost-cutting measures in 2009 will reap benefits in 2010. Yet at most firms—even those that took significant measures already, there is ample room for reducing costs further. The

renewed strength of the market should not cause firms to abandon the cost cutting urgency that was prompted by the recession. Some firms that would benefit from closing satellite offices have not done so, and there are surplus and underperforming associates and partners still to be laid off. In addition, firms should re-evaluate their real estate needs and, if in a position to do so, explore the possibility of adopting partial "hoteling" models and moving support staff with backroom functions to less expensive locations.

Firms Will Need to Retool Their Hiring, Attorney Development, and Compensation Practices

► **At the Associate Level:** The sustainable solution for doing away with associate surplus and for retaining productive performers at all associate levels is to become more strategic in associate hiring, to devote greater attention to associate development, and to promote and compensate associates using a merit-based system that is grounded on a competency model, rather than on seniority. The significant layoffs of associates that started in the fall of 2008 and the deferral of the start dates of associates in the class of 2009 make it clear that, more than ever, firms need to predict their future staffing needs more realistically, and to hire and promote accordingly.

We urge the vast majority of the Am Law 100 and the "second hundred" firms to move away from a starting salary for first-year associates equal to what the top New York and other highly profitable firms pay. So far, only a handful of firms have made that move. Instead, in recent months we have witnessed a shift in the wrong direction: the vast majority of the Am Law 100 that had retreated from a first-year salary of \$160,000 has now reverted to that number as a salary base-line for incoming associates. Interestingly, the recent rebound in the first-year salary level appears to have been driven by increases given to senior associates, in some cases by firms that felt they had to increase compensation to retain those associates; historically, pay increases in the starting year were what drove corresponding increases for the senior associates. We believe that ultimately, competitive pressures will force firms to rethink their starting salaries and associate compensation structures.

► **At the Partner Level:** We urge law firms to take bold action to ensure the productivity of their partner ranks, not only by counseling out underperforming partners, but also by reassessing the criteria used to determine which senior associates

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⁴ Thomson Reuters news release, "Thomson Reuters Releases First Quarter 2010 Global Investment Banking Reviews," April 7, 2010, available at http://www.japancorp.net/Article.Asp?Art_ID=22657.

will be promoted to partner. Several firms have indicated that they have taken steps already to implement tougher promotion standards, and many also de-equitized partners in 2008 and 2009. In fact, it bears noting that the growth in PPEP that some Am Law 100 firms experienced in 2009 might be attributable to their having had fewer equity partners to share in the profits, and not only to their cost cutting. Many of the firms might have experienced even greater PPEP growth if the partners they laid off had left the firm already. Partners generally are given longer grace periods to depart than are associates, so it is likely that in 2010 and 2011 some firms will reap the benefits of earlier partner lay-offs.

An Increasingly Competitive Market Demands Distinctive Value Propositions

The marketplace will continue to become increasingly competitive, forcing firms to develop a distinctive value proposition if they wish to retain or expand their share of clients and work. Practically speaking, firms need to continue to develop strength in their core competencies, especially in areas in which they are known as a "go-to" firm. Some firms have resumed investing in branding and positioning as the recession wanes, which is a sound strategy, including for the "second hundred" firms that, as we noted earlier,

have taken advantage of their lower billing rates to attract work away from the Am Law 100. To continue to reap the benefits of lower pricing in a marketplace that is still very rate-sensitive, the "second 100" firms must continue to invest in their brands to increase visibility in their most profitable markets.

CONCLUSION

The historically widening profitability gap between the top-performing firms and the rest of the market that had begun to narrow in 2008 did so again last year, and even more significantly. However, we believe that in 2011, and perhaps even in 2010, if the top firms position themselves strategically to retain work in a changed marketplace, they will resume their pace-setting profitability trajectory as the economy strengthens, and the window of opportunity for the rest of the market will begin to close.

We expect that throughout 2010 our clients will continue to confront both significant challenges as well as new opportunities as they seek to develop sound strategies to guide growth, to enhance their brand and market positions, and to strengthen key client relationships.

As always, we welcome your feedback to this *ZG Alert*.



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