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## Game over?

**The global legal market in 2018**

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MASTERCLASS

# Game over?

Markus Hartung and Arne Gärtner provide a strategic analysis of which international law firms will be market leaders in 2018

## THREE THINGS YOU WILL LEARN FROM THIS MASTERCLASS:

- 1 The major trends shaping the global legal market between 2008 and 2018
- 2 The impact of those changes on the market position of international law firms
- 3 The key considerations for managing partners formulating three-year plans for their firms

Looking into the past can be of use when formulating your firm's next three-year plan. Until 2008, life in the global legal market was relatively easy. Strong economic growth and the availability of easy funding worldwide led to significant merger activity. Commercial law firms enjoyed spectacular growth, benefitting from a surplus in demand, a severe lack of sophistication in buying legal services and the absence of new and/or innovative legal service providers. The traditional business model of law firms, building on a cost-plus margin system, helped them to increase profitability significantly without the need for proper management structures or efficient service delivery. This was the 'golden age' of the legal industry.

The success of commercial law firms – out of line with growth figures in other industries – was watched with growing scepticism by companies and their suppliers, which increasingly focused on reducing costs, while increasing the quality and value of their products and services. The only outlier seemed to be law firms.

Following the 2008 financial crisis, the scene changed dramatically. Business activity and demand for legal services collapsed sharply, immediately changing the balance of power between law firms and clients. Almost overnight, the excess in demand shifted into a supply surplus, resulting in a 'total reset'. Today, law firms are under immense pressure, faced with shrinking books of business, reduced bank financing, high overheads and low utilisation.

The situation remains tense. Demand growth prior to 2008 was at a healthy rate of 3.9 per cent; growth has since flattened

or even turned negative. Law firms need to focus on growing or at least maintaining their market share (and profitability) in the current unstable environment.

But, most commercial firms are unfamiliar with professional strategic management and are consequently struggling to cope with new competitors such as legal process outsourcing (LPO) providers or new types of law firms.

While many firms seem to be aware that the golden age is over, their growth strategies are still tailored to the world back in 2007 when clients were easily satisfied and cost pressures were rather unheard of. Only a handful of firms have realised what 'total reset' means and are looking afresh at their current business models and seeking alternative growth opportunities.

### Strategic mapping

A useful way to understand how the legal market has changed shape since the financial crisis – and what it will look like in 2018 – is to analyse market data from 2007 until today. But, rather than overly focusing on each firm's turnover and profitability on a year-on-year basis through endless listings, we prefer to look at the strategic map of legal markets and to compare movements of certain groups of firms. This is not a new method of looking at legal markets; rather, it is a forgotten one.

The legal landscape in 2007 is mapped in Figure 1. To produce this, we took the number of equity partners in a firm and plotted them on the X-axis. On the Y-axis, we charted the profits per equity partner and thereby generated a diagram of the legal landscape. With this process repeated for each subsequent year, it is easy to follow the evolution of individual law firms as well as of different groups of law firms (which may or may not form strategic groups).

In 2007, one could identify five different groups:

- Group A: The global elite
- Group B: The challengers
- Group C: The middle field
- Group D: The magic circle
- Group E: The global law factories

The legal market in 2013 has changed significantly since then and now looks like Figure 2. What happened during this

period? And, can we draw conclusions to forecast future developments? To answer these questions, we will need to take a deeper look into the five groups and their changing position on the strategic map.

### Group A: The global elite

Law firms in the global elite focus on the quality of their services (quality leadership) and, as a result, generate very high profits per equity partner (PEP). Their creed is: elite approach, zero tolerance, no prisoners.

They do not focus on headcount growth or global coverage by having offices all over the place. The average number of equity partners in these firms has therefore remained nearly the same (97 in 2007 compared to 92 in 2013). During this period, PEP fell from US\$4m on average to US\$3.8m.

## “The middle field firms are stuck in the middle”

### Group B: The challengers

Law firms in this 'challenger' group have taken a clear strategic decision: attack the incumbents of group A. At the same time, their development to 2013 shows that not every firm will achieve this goal: while the average number of partners (150) and average PEP (US\$2.3m) remained the same, the gap between the most and least profitable firms in this group increased from US\$1.2m in 2007 to US\$2m in 2013.

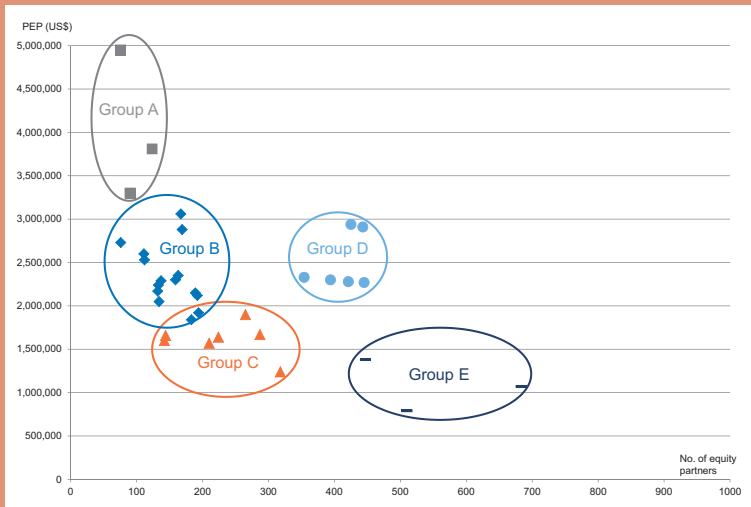
Group B is drifting apart. In future, the upper part of group B will merge with group A, as already demonstrated by some law firms, bar some casualties. But, what will be the fate of those firms at the bottom end of this group?

### Group C: The middle field

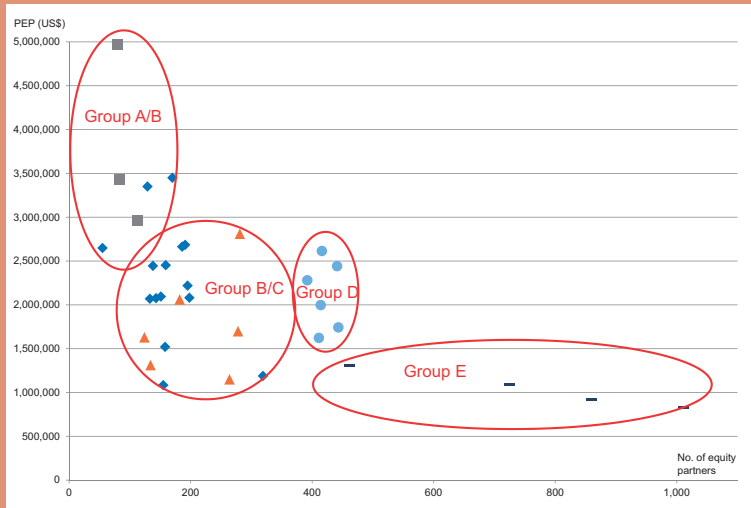
Firms in Group C shrank a little in terms of average number of equity partners (223 in 2007 compared to 211 in 2013), but managed to maintain their PEP (nearly US\$1.6m) and were able to defend their market position. But, this is not necessarily a reason to celebrate.

While law firms in groups A, D and E seem to have arranged themselves

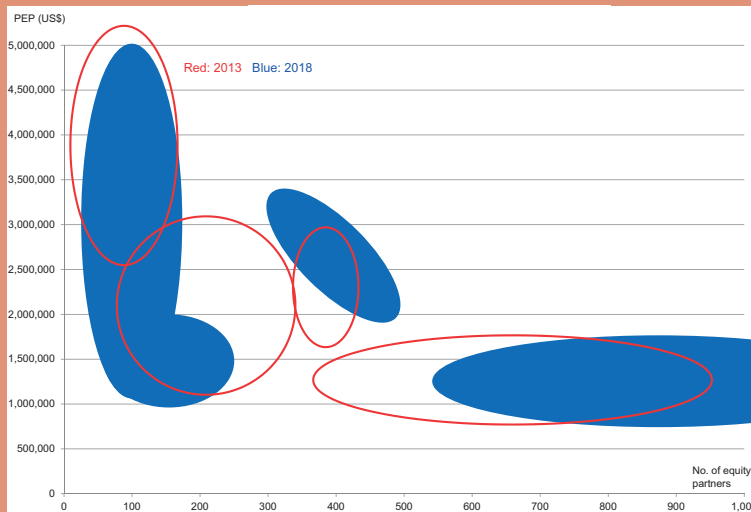
**FIGURE 1: THE GLOBAL LEGAL MARKET IN 2007**



**FIGURE 2: THE GLOBAL LEGAL MARKET IN 2013**



**FIGURE 3: THE GLOBAL LEGAL MARKET IN 2013 VS. 2018**



with the new competitive situation on the legal market – or at least began to adapt to the new situation – the future of group C is unclear.

Most of the law firms in groups A, B, D and E have already decided in which direction they are heading – they will either try to become more profitable or they will become bigger; both approaches bring competitive advantages. But, law firms in group C cannot develop in either of these possible directions because they would end up competing with the incumbent firms. Hence, the middle field firms are stuck in the middle.

**Group D: The magic circle**

Firms in the magic circle (plus Latham & Watkins and Skadden) clearly lost in terms of PEP (US\$2.1m in 2013 vs. US\$2.5m in 2007), but remained stable in terms of number of equity partners (413 in 2007 vs. 420 in 2013). The question is whether these firms will stay together as a group or if they will follow different strategic approaches and, as a result, this group will disappear in the long run.

There seems to be no way to either become significantly more profitable while retaining the same size or to become considerably bigger while remaining as profitable. Hence, law firms in group D have to decide which way they want to grow.

The third possible approach – to become significantly bigger and simultaneously more profitable – is not a real option since the legal market appears to have a natural limit which, most likely, will remain at the same level due to ongoing pressure from clients.

**Group E: The global law factories**

Firms in group E put emphasis on growth in terms of headcount, offices and global reach. In 2007, three law firms (Baker & McKenzie, DLA Piper and Jones Day) counted 550 partners on average. Since the June 2013 merger of Norton Rose Fulbright, these four firms consist of 960 equity partners on average. They follow a seemingly clear strategy, covering markets globally.

Average PEP decreased slightly from US\$1.1m to US\$960,000, but this is due to Norton Rose Fulbright diluting

**FIGURE 4: BREAKDOWN OF LAW FIRMS**

Group	Firm Name	PEP 2007 (US\$)	PEP 2013 (US\$)	# of Partners 2007	# of Partners 2013
A	Cravath	3,300,000	3,435,000	90	83
A	Slaughter & May	3,820,000	2,958,000	127.4	113
A	Wachtell	4,950,000	4,975,000	75.5	79
B	Ashurst	2,170,000	1,084,000	132	155
B	Cadwalder	2,730,000	2,649,000	76	55
B	Cleary	2,150,000	2,685,000	189	191
B	Davis Polk	2,300,000	2,453,000	159	159
B	Debevoise	2,290,000	2,076,000	137	143
B	Dechert	2,350,000	2,095,000	163	151
B	Herbert Smith	2,050,000	1,189,000	134	319
B	Milbank	2,530,000	2,445,000	112	138
B	Paul Hastings	1,920,000	2,081,000	194	198
B	Paul Weiss	2,600,000	3,350,000	111	129
B	Shearman & Sterling	1,840,000	1,521,000	183	158
B	Simpson	2,880,000	2,664,000	169	186
B	Sullivan	3,060,000	3,450,000	167	170
B	Weil	2,120,000	2,219,000	192	195
B	Wilkie	2,240,000	2,070,000	133	133
C	Fried Frank	1,600,000	1,313,000	142	134
C	Gibson Dunn	1,900,000	2,811,000	265	281
C	Mayer Brown	1,240,000	1,151,000	318	264
C	O'Melveny	1,640,000	2,062,000	224	182
C	Orrick	1,660,000	1,630,000	144	124
C	White & Case	1,670,000	1,700,000	287	278
D	Allen & Overy	2,330,000	1,744,000	354	443
D	Clifford Chance	2,300,000	1,624,000	394	411
D	Freshfields	2,910,000	2,281,000	443	392
D	Latham	2,270,000	2,443,000	445	441
D	Linklaters	2,940,000	1,998,000	425	414
D	Skadden	2,280,000	2,615,000	421	416
E	Baker & McKenzie	1,070,000	1,090,000	683	725
E	DLA Piper	1,380,000	1,308,000	447	462
E	Jones Day	790,000	915,000	510	859
E	Norton Rose Fulbright	(see note)	833,500	(see note)	1,011

Sources for 2007 data: Am Law 100, Global 100, McKinsey analysis. Sources for 2013 data: Legal Business 100 2013

**Note:** Given that the merger between Norton Rose and Fulbright & Jaworski took place in 2013, we have no data for 2007. We nevertheless decided to include Norton Rose Fulbright in 2013 since the firm clearly became a member of Group E.

the results; excluding it, the group managed to marginally increase average profits per partner.

### Current trends

Let's examine the major trends shaping the legal market today and in future. Clearly, price pressure or, more precisely, the more-for-less challenge will dominate. This is not the flavour of the day; quite the opposite – this challenge is here to stay. It is caused by the decreasing

information asymmetry between lawyers and their clients.

As a rule of thumb, the bigger the information asymmetry, the more lawyers can charge for their services. With companies further developing their in-house legal departments and an increasing number of lawyers moving from private practice to in-house positions, the information asymmetry is diminishing.

Buyers of legal services have consequently been trying to 'unbundle'

their legal needs into separate components, looking for the best and most efficient provider for each component. Traditional law firms don't rank on the top of corporate counsels' lists of service providers; value is increasingly being measured by metrics rather than the age of the firm, and this trend is expected to continue.

### ABSs and LPOs

Today it is a common view that traditional law firms, alternative business structures

**CASE STUDY: A CATEGORY KILLER**

Pusch Wahlig Legal is one example of the trend in Germany of building up smaller units. Founded in 2006, the firm is based in Berlin and employs five partners, one counsel and ten associates. The partners previously worked at full-service international law firms like Allen & Overy, Cleary Gottlieb and Salans.

Tobias Pusch, previously head of the local labour and employment law practice group at Allen & Overy in Hamburg, saw four trends which led him to decide to set up the boutique employment law firm.

First, a lot of employment law advice was being delivered as an annex to M&A deals. This strong transactional driver reduced the scope of work in the labour and employment law practice significantly and therefore made it less interesting to work in that field.

Second, the premium hourly rates charged by magic-circle firms further reduced the scope of potential clients. While these rates were acceptable to clients for international transactions, they were difficult to agree upon for general employment law advice.

Third, the enormous pressure towards increasing profitability in the largest law firms resulted in less flexibility for partners and associates to achieve work/life balance in different phases of their lives.

Fourth, there were significant differences in the quality of advice and depth of experience in employment law from individual offices at global full-service law firms. There was a correlation between the average quality level of the employment law teams globally and the transaction focus of the firm: the higher the transaction focus, the greater the likelihood of finding top-quality

employment lawyers in only some of the global offices instead of all of them.

Over the past seven years, Pusch Wahlig has sought to address these issues. It adopted a pricing policy which is between that of magic circle and local law firms. It capped its overheads by servicing the whole German market from rented 1B-location offices in Berlin, in which the salary level and rental costs are significantly lower than in other big German cities.

It allowed for work/life balance by accommodating flexible working at all lawyer levels; currently, 30 per cent of associates are employed part time. It established an internal employment law academy for trainees and associates, in addition to an associate development programme leading to partnership. The remuneration system for partners combines lockstep with merit-based components. Partners also benefit from secondments across the labour and employment law firm alliance L&E Global, which the firm co-founded in 2010.

The firm's focus on a medium cost structure, combined with a medium price point and modern talent management approaches, has helped it to grow with a very competitive price structure, while attracting and retaining high-quality lawyers.

The firm has developed a reputation for providing clients with innovative product-based approaches to standardised issues, such as creating employment contracts as a service. It also created an HR/legal calendar, helping clients to actively manage recurring themes with works councils before issues arise. Finally, the firm is about to introduce a balanced scorecard to improve the management of its 30+ employees and increase client satisfaction.

(ABSs) and LPOs are completely different animals which may or may not compete with each other. ABSs are regarded as threats to high street firms, not to international or global law firms. LPO provider are accepted as being part of the food chain, delivering bulk services to law firms or to clients directly, but are kept out of 'reserved activities', with limited room for manoeuvre: legal services yes, legal advice no. This may be entirely artificial, but it will remain the status quo, at least for the foreseeable future.

But, things will change even under the status quo: within the next three to five years, law firms will have understood that an ABS is not only a new breed of law firm providing day-to-day advice to consumers but also a tool allowing LPOs to join forces with traditional law firms rather to continue as their competition.

Law firms have for some time tried to establish their own captive centres, but even the average LPO provider is leagues ahead of law firms in providing commoditised services. The first law firm to combine LPO capabilities with that

what 'only lawyers can do' will achieve considerable competitive advantages. It will be in the position to offer truly end-to-end services to clients, with high quality, innovative and highly competitive fee arrangements.

**Future considerations**

Let's now look at where major commercial law firms will be placed in the global legal market in 2018. There are, of course, no crystal balls or guarantees; our analysis is based solely on publicly-available market data and recent

developments. From that, we have derived the following conclusions.

Whilst we identified five groups in the 2007 analysis, the scene has changed in 2013, showing four groups rather than five:

1. the premium elite (group A and partly group B);
2. the magic circle (group D);
3. the global law factories (group E); and
4. the middle field (partly groups B and C).

Taking into consideration recent developments and apparent trends (and bearing in mind that Chinese law firms with global reach and ambitions are a relatively new phenomenon), we believe the legal landscape in 2018 will look like Figure 3.

To start with the easy part of forecast, the premium elite segment (group A and partly B) will remain. We are not concerned about the prospects of New York 'white shoe' firms such as Cravath and Wachtell. Sticking to their purist elite

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**“The brand ‘magic circle’ will probably survive, but the strategies of Allen & Overy, Freshfields et al no longer have much in common”**

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approach, on the back of a strong US economy and, with their premium brand, their market position will be in perpetual motion.

The elite will however have to fight hard to defend their market position, focusing on profitability rather than revenues. This is actually the only option for the global elite, since becoming bigger would automatically cause them to deviate from their elite model and become less profitable.

We seriously doubt whether all firms aiming to get access to this club will succeed. Looking at the landscape, we would expect an upright standing ellipse, with a small group on top of the ellipse.

The next bit which appears to be rather easy to predict is group E, the global law factories. Their international reach, focused on revenues and global market share, goes together with a comparably easy to manage Swiss *verein* structure. Their primary challenge will be to maintain or even improve profitability. Besides that, their global approach will lead to further challenges such as how to:

- ensure that all partners align with the firm's vision and implied partnership ethos;
- implement a worldwide quality management system; and
- keep the 'one firm' promise.

Just try to compare, say, Deloitte, with one of these global law factories to understand what lies before them.

As for the future of the magic circle segment, it is rather unclear. This group of firms tended to move in strategic flocks, but that seems to have faded away. For example, Slaughter and May is still regarded as part of this group, but it has pursued quite a different strategy for some years.

The brand 'magic circle' will probably survive, but the strategies of Allen & Overy, Freshfields et al no longer have much in common. Still, by the end of 2013, the four magic-circle firms had reunited in the table rankings (places one to four in the UK top-50 tables and places five and seven to nine in the global-100 rankings).

Looking closer, there seem to be two parts of the magic circle, namely Freshfields/Linklaters on the one hand and Clifford Chance/A&O on the other. For Freshfields/Linklaters, the route seems to be pretty clear as they will just continue

their way towards the elite segment. For Clifford Chance and A&O, this is less clear.

What will happen to those firms that were part of group C back in 2007? They do not have the potential to seriously compete with the premium segment of the market – at least not in their current size and shape. They are in an uncomfortable sandwich position, literally stuck in the middle – too small to compete with the Norton Roses of this world and with no premium brand to significantly trade up their business. In addition, these firms suffer pressure from two ends: price pressure from clients and pressure from competitors who are not yet on the radar – smaller/boutique firms, category killers, LPOs and other legal service providers.

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## **“It's a growing market, so stop complaining about decreasing profits”**

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Hence, we predict that this group will disappear for traditional commercial international law firms in the long term. But, the incumbent inhabitants will not disappear as they will do everything they can to secure their sheer existence. Hence, the management challenge is easy: get out of here.

### **Main findings**

There are three main findings which managing partners at mid-sized international law firms should consider when formulating their upcoming three-year plans.

#### **1. Game over, or accept the new world order**

It's a growing market, so stop complaining about decreasing profits. The main cause of decreasing profits is not just the 'cruelty' of some clients but also the outdated business models of most law firms.

In fact, the pyramid model is older than 100 years and it is surprising that it has survived that long. In the long run, this business model will work only for a handful of law firms – the global elite. All other law firms will most likely have to

reinvent their business models – and those who start today will be most likely to be there tomorrow.

#### **2. Focus on added value**

Despite legal expertise being the natural core competency of lawyers, what is their unique selling proposition amongst all sorts of legal service providers? For a long time, lawyers could benefit from information asymmetries but, with the evolution of sophisticated in-house legal departments, these times are long gone. Law firms need to focus on providing added value, and there are two key ways to achieve this.

First, the handling of highly complex international projects and delivering ready-to-use solutions to clients could be a key competency of law firms in future. We predict that information asymmetry will be replaced by process management asymmetry (hand in hand with legal/technical excellence).

Second, a clear focus on the team approach – particularly the ability to quickly put together a team of lawyers from different practices and jurisdictions and with diverse competencies – will be another unique selling point. This is far more than the one-stop-shop of the 1990s.

#### **3. Listen to your clients and understand their needs**

The best approach for managing partners would be to talk to your most important clients and figure out how your law firm can become an essential part of the value chain.

But, beware of the innovator's dilemma trap – don't just focus on improving the services you are delivering today, but try to understand the real needs of your clients, which may well include services provided by alternative legal service providers.

Hence, a bit of reinvention could be helpful. This may cause some tough decisions for the firm as it stands today. But, your plan should build on these findings, and on these findings alone. <sup>mp</sup>

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