Dynamic Law Firms Study

**Dynamic** – An adjective of French and Greek origin in the early 19th century generally used to describe something characterized by energy or effective action. When pertaining to the science of Physics, it describes something of force related to motion. Energy; effective action; motion.

**Static** – A 16th century antonymic adjective to *dynamic* that defines something with a fixed or stationary condition that shows little or no change and lacks vitality and development.

In an attempt to better understand and frame what the benchmarks of recent positive trending law firms were, we dove into the data and identified two groups of firms within the Peer Monitor® universe to analyze based on the recent direction of their performance.

Taking the last three years into consideration (2014-2016), we analyzed the compound annual growth of law firms’ revenue per lawyer (RPL) and total profit. We also considered their average change in profit margin over that time frame. These financial indicators were chosen as they each represent important proposed pillars of law firm success: law firm value (RPL), bottom-line financial health (profit), and operational efficiency (profit margin). The relative performance of each firm in each of these categories was placed into a weighted matrix.

Those firms within the matrix who fell within the top quartile for composite scores we have dubbed *Dynamic* firms. Those firms who fell into the bottom quartile, essentially those firms who have found more difficulty in growing, or in some cases even maintaining RPL, profit, or profit-margin levels, we have labeled as *Static*. A deeper examination of the results provides the basis for the nomenclature choices.

In examining relevant key performance indicators (KPIs), it is readily apparent that the Dynamic firms not only dramatically outpaced their Static counterparts in nearly every category, but they also outpaced the Average firm within the market.

*Key Performance Indicators*®

![Key Performance Indicators Graph](image)

*All timekeepers. Billable time type; non-contingent matters*
The average Dynamic firm finished 2016 with slightly over 2% growth in overall demand, or total worked billable hours, for the year. That places the average Dynamic firm 2.4 percentage points ahead of the Average firm, and nearly seven percentage points ahead of the average Static firm. This is an important differentiator in a mature market that is increasingly known for its relatively flat average demand growth.

This increase in demand led to a substantial year-over-year increase in fees worked for the Dynamic firms. Fees worked is an analogue for accrual-basis revenue, calculated as the product of rates multiplied by demand.

Of significant note here is that the Dynamic firms do not appear to have garnered much of their market-leading profit and revenue performance as a result of substantial rate increases. The average Dynamic firm increased their rates at the same pace as the Average firm in the market, and only slightly more aggressively than their Static counterparts.

It must also be noted that despite market-leading lawyer growth, Dynamic firms did not suffer as substantial a decline in average productivity as did the other populations we examined. While average productivity for Dynamic firms contracted by half of one percent, that is markedly better than the other populations examined, and shows a population much closer to balance.

**WHAT DIDN’T MAKE A DIFFERENCE?**

We’ve already seen that rate growth didn’t drive the difference for Dynamic firms, but it’s important to know what else was found to have little impact.

<table>
<thead>
<tr>
<th>Lawyer Count</th>
<th>Among Dynamic</th>
<th>Among Static</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Lawyer Count</td>
<td>350</td>
<td>443</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Geography (HQ)</th>
<th>Among Dynamic</th>
<th>Among Static</th>
</tr>
</thead>
<tbody>
<tr>
<td>Northeast</td>
<td>12</td>
<td>6</td>
</tr>
<tr>
<td>Southeast</td>
<td>6</td>
<td>8</td>
</tr>
<tr>
<td>Midwest</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Southwest</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>West</td>
<td>5</td>
<td>7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>36</strong></td>
<td><strong>36</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Segment</th>
<th>Among Dynamic</th>
<th>Among Static</th>
</tr>
</thead>
<tbody>
<tr>
<td>Am Law 100</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Am Law Second 100</td>
<td>8</td>
<td>14</td>
</tr>
<tr>
<td>Midsize</td>
<td>18</td>
<td>12</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>36</strong></td>
<td><strong>36</strong></td>
</tr>
<tr>
<td>Global</td>
<td>11</td>
<td>10</td>
</tr>
<tr>
<td>National</td>
<td>8</td>
<td>9</td>
</tr>
<tr>
<td>Regional</td>
<td>17</td>
<td>17</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>36</strong></td>
<td><strong>36</strong></td>
</tr>
</tbody>
</table>

It cannot be said that larger firms enjoyed better performance. Am Law 100, Am Law Second 100, and Midsize law firms are all well represented among both the Dynamic and Static firms. In fact, the Static firms saw a higher average attorney count, although this is somewhat inflated by a few very large firms which pulled up the average.

Similarly, headquarters office location and regional/national/global presence did not seem to be large drivers.
SOMETHING OF A SURPRISE

Leverage is considered one of the key levers of profitability for a law firm. The ability to push work down to the lowest-cost, capable timekeeper gives law firms the ability to push work to higher-margin timekeepers, maximizing the profit potential, or so goes the theory.

But in a surprising finding in our analysis, we discovered that with few exceptions, on average, Static firms exercised greater leverage than their colleagues at Dynamic firms in nearly every measure of leverage we examined.

FTE Leverage (Lawyers to Equity Partners) – Am Law 100*

FTE Leverage (Lawyers to Equity Partners) – Am Law Second 100*

FTE Leverage (Lawyers to Equity Partners) – Midsize*

*Lawyers only
Breaking down the Dynamic and Static populations by segment, we can see that the Static firms actually outperform the Dynamic firms in both FTE leverage\(^1\) and demand leverage\(^2\) in every market segment except for Midsize firms. Conventional wisdom would have predicted that, due to generally higher profit margins and profit growth, the Dynamic firms would be found to be exercising better leverage. That this was not the case was a surprise. This is not to suggest that leverage is not an important factor to consider when searching for greater profit; however, it does lead to the conclusion that perhaps there are other factors that can combine to achieve growth.

We also tested the theory that, perhaps, the Dynamic firms had fewer non-equity, or income, partners. This particular group of timekeepers has been the source of much discussion for a number of years because they are typically rather well compensated, but do not hold an equity stake. They are also rarely viewed as rainmakers for the firm, and they typically have lower profit margins. If Dynamic firms had fewer income partners as part of their timekeeper mix, that could be a possible explanation for higher average profit margins.

However, that was not the case. In fact, on average Dynamic firms actually had a slightly higher average proportion of income partners among their lawyer timekeepers. Among Dynamic firms, on average 19.4% of their timekeepers were income partners, 35.9% were equity partners, and 34.1% were associates. By way of comparison, Static firms averaged 17.1% income partners, 34.7% equity partners, and 35.2% associates. None of these variations is large enough to be readily apparent as contributing drastically to financial outcomes.

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* Lawyers: Billable time; non-contingent matters.
\(^1\) FTE leverage is the ratio of non-equity partner attorney timekeepers to equity partners.
\(^2\) Demand leverage is the ratio of demand hours worked by non-equity-partner attorney timekeepers to hours worked by equity partners.
SO WHAT DID MAKE A DIFFERENCE?

Having looked at what didn’t move the needle and what surprised us, let’s turn to what we found that did correlate with better financial results.

Practice Demand

We’ve already discussed the higher demand growth enjoyed by the Dynamic firms in 2016. Diving into that deeper, we see that several practices contributed to this overall growth in demand.

Practice Demand

The difference in corporate work is substantial. But what is of even greater note is the demand growth Dynamic firms saw in litigation. Litigation has been in decline for much of this decade. In fact, the last time the average firm in the Peer Monitor sample saw quarterly growth in litigation demand was Q1 2012. Almost three in four (73% to be more precise) of Dynamic firms with litigation practices found demand growth in 2016 compared to the previous year. For the entire Peer Monitor program market, only 43% of firms saw growth in litigation demand over that time frame. Static firms saw an even smaller percentage yet, with less than one-third of firms finding litigation demand growth (31%).

The suggested conclusion here is that if a firm is winning at litigation, they’re likely to be winning overall. Statistically, Dynamic firms saw a coefficient of correlation\(^3\) between litigation demand growth and overall demand growth of 0.836. A result over 0.8 is considered strongly correlated. Similarly, litigation demand to overall demand for Dynamic firms had a coefficient of determination\(^4\) of 0.699. Both of these figures dramatically outpaced the same figures for Static firms, which saw results of 0.527 and 0.278 respectively.

All this is a fancy way of saying that there is a stronger relationship between litigation demand growth and overall demand growth in the Dynamic firms than the Static firms and that the predictability of the overall demand growth based on the litigation growth is quite a bit higher in the Dynamic firms than the Static firms.

One might assume that the average proportion of litigation in the firms in the Dynamic group was much higher than the Static group, which accounts for this stronger relationship, but that is not the case. Among Dynamic firms, litigation accounted for 36.2% of demand, while among Static firms, the proportion of litigation to total demand was 35.7%.

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*All timekeepers. Billable time type: non-contingent matters

\(^3\) Coefficient of Correlation measures the strength of association between two variables.

\(^4\) Coefficient of Determination is interpreted as the proportion of the variance in the dependent variable (overall demand growth) that is predictable from the independent variable (Litigation/Transactional Demand Growth).
PRODUCTIVITY

Another key differentiator for Dynamic firms was productivity, or hours worked per lawyer per month.

Hours Worked per Lawyer (per Month)*

While only five hours per month, this difference in productivity is substantial, especially when coupled with nearly identical rate growth. In effect, Dynamic firms produced, on average, 60 hours more per lawyer per year than did Static firms.

Among the Dynamic firms, most of the decline in average productivity was seen within the ranks of Of Counsel attorneys, who saw their average productivity decline by about 17 hours per month during the course of the time period examined. In contrast, nearly every timekeeper group among the Static firms saw their productivity decline, with only associates holding relatively steady.

We also noted an inversion in the productivity numbers between the two populations in late 2014 and early 2015. Coincidentally, the average profit margins for the two populations inverted at about the same time. In 2014, the firms in the Static population averaged a 37.4% profit margin while Dynamic firms managed only 35.3%. By 2015, though, those numbers flipped with Dynamic firms averaging 36.6% profit margin and Static firms slipping to an average profit margin of only 35.7%.

Profit Margin**

We cannot conclude based on this data whether there is any causal relationship between these two data sets, but the correlation is worth noting.

* Lawyers. Billable time type; non-contingent matters
**Revenue - Expenses (including non-equity partner compensation) = Profit/Revenue
RATES AND REALIZATION

We've already noted that rate growth did not make a substantial difference in the financial performance between the Dynamic and Static firms. That may beg the question, “so how far apart were their rates to start with?” In actuality, Static firms actually command slightly higher average standard rates than do their Dynamic counterparts, although not by a wide enough margin to be significant.

Although, it is interesting to note that while Static firms have a slightly higher standard rate, they lose that advantage as the full rate progression is examined. Static firms’ average standard rate is about $5 per hour higher than the average Dynamic firm. But Dynamic firms enjoy a collected rate that is $5 per hour higher than Static firms.

This is all a function of realization.

Realization Against Standard*

Dynamic firms had a substantially higher billing realization, meaning they offered less to their clients by way of initial discounts off of standard rates in order to win the business, and they engaged in fewer pre-bill write-downs. In fact, it appears that Dynamic firms have been undertaking efforts to reduce the amount of discounts and write-downs offered, resulting in an increased billing realization over the period studied.

Dynamic firms have seen their billing realization stay consistently 2 to 2.5 percentage points higher than the billing realization of Static firms. The gap between collected realization for the two populations is even larger, nearly 3%, with Dynamic firms realizing an average of 83.9% of their standard rate at the end of 2016, while Static firms realized only 80.8%.

Of note here is that the gap between billing realization and collected realization has not widened appreciably for either population. Both have hovered around a 3 percentage point gap. It cannot be said that clients are being harder on Static firms in terms of the write-offs or discounts they are demanding after receiving their invoices. Rather, it appears that most of what has been driving down realization for Static firms has been self-inflicted.

There has been no dearth of words written about increasing client pressures on law firm rates. Clients want to see better value for their legal expenditures, and law firms have translated this to mean clients wanting work done “cheaper.” Law firms want to be good stewards of their clients’ financial interests, so much of the desire on the part of law firms to deliver better value has manifested itself in bill reductions. Particularly for our Static firms, it becomes a bit of a chicken-or-the-egg question as to what extent the discounts and write-downs they are offering are the result of actual client pressures, and how much are the result of fear of the same.

It is instructive that Dynamic firms have actually grown their billing realization, and with it their collected realization.

* Lawyers. Billable time type; non-contingent matters
Among the Static firms, the average proactive discount offered from standard rates has averaged 8.7%. A further 8.4% is lost to pre-bill write-downs, with a final 4.6% disappearing due to client-requested discounts or write-offs. Nearly all of this is due to decisions made within the firm. Dynamic firms, on the other hand, average a 7.4% up-front discount, a 7.0% average write-down, and a 4.0% client write-off.

Standard rates only tell part of the story. Unsurprisingly, Dynamic firms also do a better job of collecting against their negotiated rates.

**Collection Realization Against Worked (Agreed)**

For most of 2014, Static firms kept pace with Dynamic firms in terms of worked rate collections. Since then, Static firms have seen their average worked rate realizations decline while Dynamic firms have seen their realizations against worked rates increase along with their realizations against standard. The factors driving this departure are the same as those influencing the deltas seen in standard rates and are largely a matter of what the firm is doing in terms of write-downs.

It’s also worth noting that, for both populations, fixed-fee agreements comprise slightly less than 25% of the firm’s total revenue, according to survey responses. But there is a substantial difference in how the two populations approach alternative fee arrangements (AFAs).

Fully 75% of responding Dynamic firms report that they proactively pursue AFAs. Conversely, 70% of responding Static firms offer AFAs in a reactive fashion in response to client requests. For several years, Altman Weil in the *Law Firms in Transition* survey has examined AFAs and whether proactive pursuit or reactionary offerings lead to better financial results. Nearly without fail, the survey’s results show firms that pursue AFAs proactively experience better outcomes. The same seems to hold true here. This is, of course, another example of internal behaviors and strategies that can drive ultimate performance.

Firms looking to boost their realization percentages would do well to look at internal factors that may be driving realization down before turning to externalities like asking how to get a client to pay a higher percentage.

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* Lawyers. Billable time type; non-contingent matters
EXPENSES

Expenses are one of the key areas where the Dynamic and Static populations earned their names. The Dynamic firms saw expenses increase in nearly every category in the rolling 12-month period ending in December 2016. In contrast, Static firms saw many areas of expenditures decline, and even those that did grow did so at a much slower pace than their Dynamic counterparts.

Overhead Detail

![Overhead Graph]

<table>
<thead>
<tr>
<th>Category</th>
<th>Q4 '16 (Dynamic)</th>
<th>Q4 '16 (Static)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Staff Comp</td>
<td>-2.3%</td>
<td>0.2%</td>
</tr>
<tr>
<td>Benefits</td>
<td>2.9%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Occupancy</td>
<td>3.4%</td>
<td>2.7%</td>
</tr>
<tr>
<td>Office</td>
<td>4.6%</td>
<td>4.2%</td>
</tr>
<tr>
<td>Technology</td>
<td>4.0%</td>
<td>3.8%</td>
</tr>
<tr>
<td>Marketing &amp; Biz Dev</td>
<td>5.9%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Library</td>
<td>6.2%</td>
<td>5.8%</td>
</tr>
<tr>
<td>Outside Services</td>
<td>9.0%</td>
<td>8.0%</td>
</tr>
<tr>
<td>Recruiting</td>
<td>21.5%</td>
<td>20.7%</td>
</tr>
<tr>
<td>Professional</td>
<td>15.2%</td>
<td>14.7%</td>
</tr>
</tbody>
</table>

Proportion: Dynamic 28% Static 15% Office 24% Outside 8% Marketing 8% Technology 4% Library 4% Staff Comp 3% Benefits 1% Recruiting 0.2%

Dynamic Firms Expense Growth

![Dynamic Expense Graph]

Dynamic Direct (solid orange line) and Dynamic Overhead (dashed orange line).

Static Firms Expense Growth

![Static Expense Graph]

Static Direct (solid black line) and Static Overhead (dashed black line).
In researching for this piece, we noted that the Consumer Price Index inflation rate for 2016 was 2.1%. That means static firms actually grew their investments in both technology and BD by less than the margin of inflation.

In what appears to be a direct effort to capture market share, Dynamic firms increased their per lawyer marketing and business development expenses by 4.6% during 2016, while Static firms grew their BD expenses by a relatively anemic 1.8%. Similarly, Dynamic firms grew their investment in technology by 3.2%, while Static firms invested only an additional 1.2% in their technology in the same period.

This seems to represent a difference in philosophy toward demand growth between the two populations that could be characterized as “investment versus status quo.” The higher performing firms seem to place a focus on building their market share through an increased focus on marketing and business development efforts, while simultaneously increasing their adoption and utilization of technology to improve workflow. Those firms struggling with financial performance seemed to take a much more conservative stance; growth of less than 2% for either marketing/BD or technology could not really be seen as taking a significant step toward future development in either of these areas.\(^5\)

We surveyed Dynamic and Static firms via an online survey to ask them some specifics about what aspects of technology and BD were the focus of their increased investments. We intentionally left the questions open ended so as to not inadvertently exclude possible growth areas. Even without a list of options from which to choose, many participants in the online survey offered similar responses.

Among the Dynamic firms, the most frequently cited example for increased focus among BD efforts was increased client interactions and direct client meetings. These firms also cited BD coaching as an area of focus, as well as brand development. When asked which single BD effort had proven to be the most successful, many of the Dynamic firms cited either direct client interactions or BD coaching as the most effective initiatives.

Static firms were not all that different in their responses. Many of them also said that direct client meetings were the most effective business development strategy. However, they also cited lateral hiring, events, and client teams as common strategies.

In terms of technology investments, Dynamic firms most often said that they were investing in technology to improve workflow efficiency, as well as to enhance their ability to assess profitability and analyze data.

Static firms were similar in that they too said they were investing in workflow improvements. They also pointed to adoption of mobile work-from-anywhere solutions as an area they saw as leading to positive results.

It’s notable here that the responses between the two populations are not widely dissimilar in their focus. But one cannot help but wonder if the increased investment on the part of Dynamic firms has helped to contribute to better results on similar strategic initiatives.

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\(^5\) In researching for this piece, we noted that the Consumer Price Index inflation rate for 2016 was 2.1%. That means static firms actually grew their investments in both technology and BD by less than the margin of inflation.
CASH MANAGEMENT

The final area of difference we examined dealt with cash management. Speed of billing is often included in any analysis of factors that impact law firm profitability. While not necessarily a factor that will dramatically improve a firm’s profitability if done well, poor cash management and slow billing can certainly degrade a firm’s profitability.

When examining our Dynamic and Static firms, it’s clear that Dynamic firms do enjoy a bit of an edge.

Looking first at average billing speed and average collection speed, we see that Static firms actually enjoy a slight edge in average billing speed, but that edge quickly disappears as bills are collected. For whatever reason, Static firms have shown an ability to get their bills to their clients quickly, but seem to have difficulty collecting on those bills as quickly as their Dynamic competitors.

That same edge is readily observed when looking at average A/R days outstanding, where Dynamic firms enjoy an edge of slightly more than four fewer days of outstanding accounts receivable. Here again, it’s not that the speed at which Dynamic firms are collecting is necessarily boosting their profitability by a considerable margin. Rather, it’s more likely that difficulty collecting against outstanding accounts receivable is negatively impacting realizations at Static firms, and thereby weighing their financial performance down.

CONCLUSION

Dynamic firms show measureable signs that they are taking effective action. They’re moving forward with investment growth in key areas of technology and marketing & business development. They are succeeding in winning demand in a seemingly tough and competitive market, especially in litigation work. They are more fully taking advantage of the capacity of their timekeepers through better utilization. And while they are growing rates like the rest of the market, they are exceedingly more willing and able to hold their ground in areas of which they can control, such as the percentage of rates that are written down.

Firms whose trends have mired over the past few years are more likely to be reactive or even static in their approach, and this shows in the results.

The precise strategies to success within firms aren’t necessarily the same across the industry, nor should they be as law firms are equally diverse in their challenges as the prescribed resolutions to those challenges, but the central thematic approaches seem to be recurrent. These themes are no more unfamiliar than the law these firms skillfully navigate; focused, proactive, explorative, and efficient approaches to each distinct area of the business and practice of law.

* All timekeepers. Billable time type; non-contingent matters

Want to see how your firm compares to these groups? Contact Ruth Bowen at 651-687-6891 or Ruth.Bowen@thomsonreuters.com