PLAYBOOK: 5 STRATEGIES OF TOP FIRMS

The most profitable firms have several traits in common. How does yours compare?

BY WILLIAM D. HENDERSON AND EVAN PARKER

A BIG PART OF A LAWYER'S STOCK-IN-trade is confidence. We know this because for years we've used data to help lawyers test their business judgment—and we've encountered countless variations of the statement, "The data are wrong." But the data often show that, in fact, conventional law firm wisdom is wrong.

This article is for the subset of lawyers willing to acknowledge that their firm's business strategy might rest on unexamined or faulty assumptions.

Drawing upon a data set built to test the financial benefits of several law firm strategies, we identify five empirically grounded paths to increased law firm profitability. A playbook, so to speak.

We derived these strategies for success from the information in the chart at right, which shows the statistical relationships between average partner compensation (the profitability outcome) and various firm attributes, or "predictors," that could potentially drive profitability.

These attributes represent strategic

PREDICTORS OF PROFITABILITY

This chart shows the relationship between average partner compensation and various firm attributes. Attributes to the right of the baseline are associated with higher profitability. The further a dot is from the baseline, the stronger the effect.

Practice Area Concentration
Investment Banking
Geographic Concentration
Financial Workouts
M&A, Capital Markets, Emerging Businesses
Hedge Funds/Private Equity
Intellectual Property
White-Collar Litigation
Antitrust
Bankruptcy
Other Practices
Industry Concentration
Trusts and Estates
Business Law
Real Estate and Construction
Regulatory Practices
Litigation
Total Attorney Head Count
Labor and Employment

Predictor

–0.4 –0.2 Baseline +0.2 +0.4 +0.6

Average Partner Compensation (Log Scale)

choices that all firms confront: whether to build out specific practice areas, focus on particular client industries or expand geographically. A key benefit of our statistical model is that it allows us to isolate the importance of each strategy, all other factors being equal.

Here's how to read the chart: The gray baseline reflects average profitability across The Am Law 200. The orange and green dots represent a predictor's effect—a green dot means that the predictor has a positive effect on compensation, and an orange dot means that it has a negative effect. The further the dot is from the baseline, the stronger its effect. Thus, firms with "more" of a green attribute also have higher partner compensation.

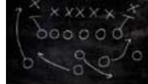
Lines going through the dots reflect confidence intervals, which capture the range of uncertainty in the estimated relationships between profitability and each of the predictors. When a green or an orange line does not intersect the baseline, we can conclude that the attribute's importance is especially meaningful, or statistically significant.

To acclimate readers to the power of a statistical model for evaluating firm strategy, we present our findings from most obvious to least. Findings that corroborate what you're certain is true should instill confidence that our model's implications are sound. In contrast, findings that are not obvious can surprise partners and inform long-standing debates within firms about what are and aren't successful strategies.

STRATEGY 1

HAVE A LARGE AND DISTINCTIVE FINANCIAL SERVICES PRACTICE.

That practice should focus on investment banking, M&A and/or private equity. This strategy is not surprising. Yet it's not available to most firms today. In a 2010 study, Peter Sherer, professor at



the Haskayne School of Business at the University of Calgary, Canada, ranked New York City firms according to their size during the 1920s and 1930s. Sherer's study showed that the firms at the top of the 1940 league tables were all Wall Street firms that exited the Great Depression with institutional relationships with the major commercial and investment banks.

Remarkably, those lists had barely changed 70 years later, with Milbank, Tweed, Hadley & McCloy; Sullivan & Cromwell; Shearman & Sterling; White & Case; Cravath, Swaine & Moore; Davis Polk & Wardwell; and Simpson Thacher & Bartlett occupying the top seven spots, Sherer found.

Some might argue that the only way to implement this strategy is to invent a time machine, and we partially agree with that. Yet there is much to gain by understanding how two non-New York firms entered the lucrative financial services market in New York. In particular, Latham & Watkins and Kirkland & Ellis had a focused strategy, made long-term investments, and stayed remarkably disciplined for more than two decades. Those firms were likely aided by extraordinary leadership and a culture that was willing to share risk.

STRATEGY 2

AVOID LOTS OF LABOR AND EMPLOYMENT LAWYERS (UNLESS L&E IS YOUR FOCUS).

Law firm partners are also likely to see this as an obvious strategy, as labor and employment has been commoditizing and moving downstream for years. Our results make clear that, all else being equal, firms with more L&E attorneys have significantly lower partner compensation. (For firms that concentrate on L&E, the story is more nuanced; see Strategy 5.)

Yet, is profitability the only financial metric worth optimizing? Over the last 15 years, growth in gross revenue has pushed three firms—Littler Mendelson; Ogletree, Deakins, Nash, Smoak & Stewart; and Jackson Lewis—from the middle of The Am Law 200 to the middle of The Am Law 100.

A CENTRAL OFFICE—OR MANY?

These Am Law 200 firms have the highest and lowest scores for geographic concentration. Highly concentrated firms have most, if not all, of their lawyers located in a single office.

Law Firm | **Highest Geographic Concentration (Top 20)**

Williams & Connolly
Wiley Rein
Wachtell
Sills Cummis
Patterson Belknap
Choate Hall
Cahill
Rutan & Tucker
Cravath
Arnall Golden Gregory
Schulte Roth
Kramer Levin
Herrick
Moore & Van Allen
Paul Weiss
Munger Tolles
Morris, Manning & Martin
Goulston & Storrs
Irell
Fitzpatrick

Lowest Geographic Concentration (Bottom 20)

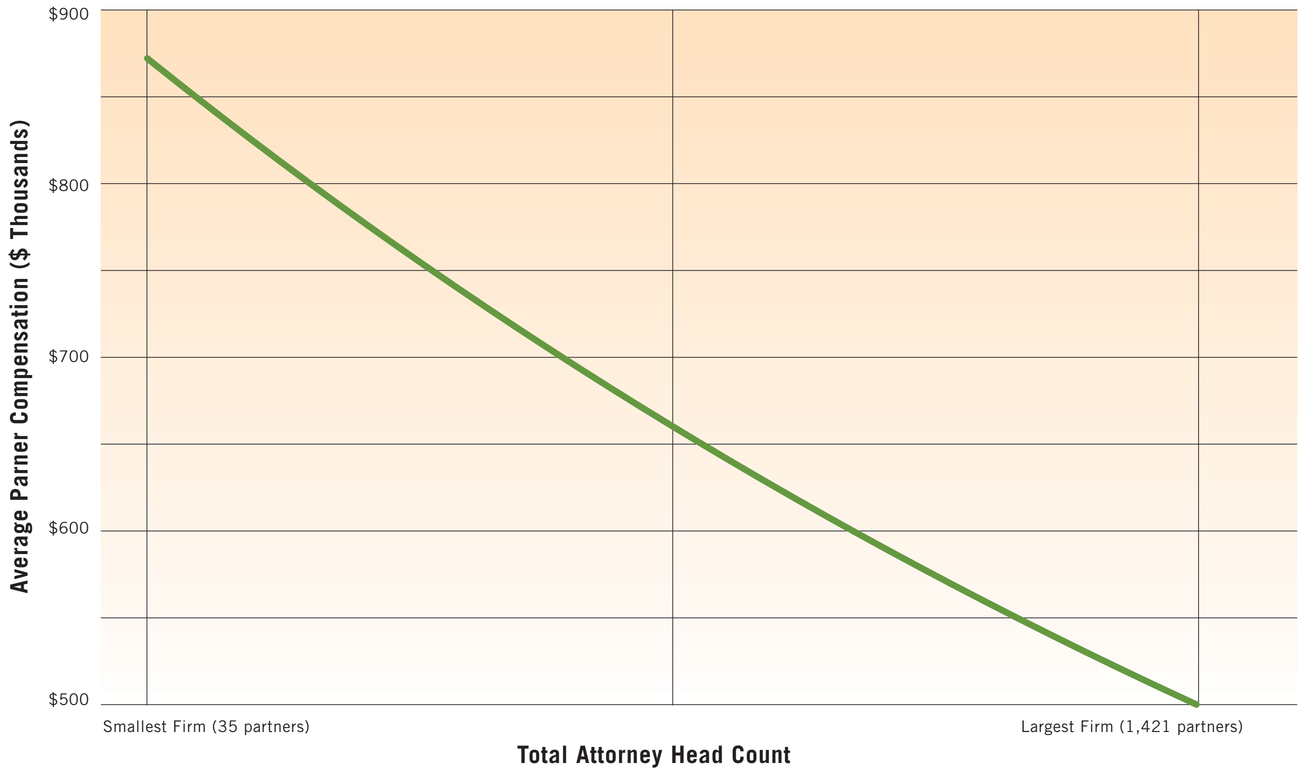
Baker Donelson
Hogan Lovells
Reed Smith
LeClairRyan
White & Case
Latham
Holland & Knight
Fox Rothschild
Fragomen
Fisher & Phillips
Fulbright & Jaworski
Squire Patton
Jones Day
Greenberg Traurig
K&L Gates
Jackson Lewis
Ogletree Deakins
DLA Piper
Littler
Baker & McKenzie

Lowest = 0 | 0.50 | Highest = 1

Geographic Concentration Score

THE COST OF BEING BIG

The more partners a firm has, the lower the average partner compensation. Partners at a firm with a small partner head Count receive roughly $400,000 more on average than those at a firm with a large partner head Count, all else being equal.



These three firms now own nearly 10 percent of the national labor and employment market, with a diversified client base of Fortune 500 companies ["Your Firm's Place in the Legal Market," December 2015].

The main attraction of the national L&E strategy is stability. Sure, partners might be making more money at higher-flying Am Law 200 firms, but what are the odds that Littler, Ogletree, or Jackson Lewis will go the way of Dewey & LeBoeuf, Howrey or Brobeck, Phleger & Harrison? Many firm partners are comfortable trading in higher pay plus risk for lower pay plus security.

STRATEGY 3

EMBRACE A HEADQUARTERS MODEL; CONCENTRATE LAWYERS GEOGRAPHICALLY.

This strategy is subtler than the preceding strategies. The measure is similar to how the Department of Justice or the Federal Trade Commission might use a statistic called a Herfindahl Index to assess market concentration for antitrust purposes. Here a score of 0 reflects perfect competition among a large number of commodity suppliers (no concentration) and a score of 1 reflects a market dominated by a single monopolist (complete concentration).

In our geographic concentration measure, a score of 0 represents a firm with an equal number of lawyers spread across a large number of offices. The national L&E firms and the vereins are closer to this end of the continuum. At the other end, a score of 1 represents a firm with a single office. (See chart at left.) Notably, with this metric, it's possible to have several branch offices and still have a high concentration score. This occurs when a large proportion of lawyers are in a single location.

Although geographic concentration is much more likely to occur in cities with rich labor markets, it is critical to note that we are not picking up a New York City effect, or even a large-city effect. The reason is that the model also accounts for the proportion of a firm's lawyers in specific metropolitan areas and foreign locations. (Those results are not reported.) What we're examining is the impact of lawyer geographic concentration separate from where lawyers are located. The geography and profitability connection does not hinge on where a firm concentrates its business but on the fact that it is concentrated somewhere.

Economic geographers have previously identified this positive relationship between the geographic colocation of knowledge workers and organizational performance. The most common interpretation of this pattern is that complex problem-solving is enhanced by the communication benefits of in-person meetings. Stated another

way, lawyers become better when surrounded by many other capable lawyers in a single physical location.

STRATEGY 4

BIGGER IS NOT BETTER, AT LEAST FOR PROFITABILITY.

The longer the market for corporate legal services remains flat, the more we expect to see mergers and lateral activity designed to boost firm size. Lawyers and firm managers often associate size with safety, and thus pursue head count and top-line revenue increases as key strategic goals. Indeed, the departure of 30 lawyers is a much bigger blow to a 300-lawyer firm than a 900-lawyer firm.

Yet our findings strongly indicate that this too-big-to-fail mentality exacts a toll on profitability. Firms with higher attorney head counts are less profitable, all else being equal. A bigger firm is harder to manage and more prone to factions, and generally dilutive of the cultural aspects that inspire trust and risk-sharing. So in the longer term, the return on growth for growth's sake appears to be mediocrity. And as we all know, sheer size does not inoculate a firm from failure. (See Dewey & LeBoeuf, Finley Kumble and others.)

We have covered this theme previously ["Playing Not to Lose," February 2013]. Understanding the difference between good and bad growth requires lawyers to think fairly deeply about the legal market and the necessity of having an intelligent and well-executed strategy.

Unfortunately, many partners are so immersed in details of their practices that they become a liability when it comes time to question or support strategy decisions that affect the long-term interests of the firm.

STRATEGY 5

FOCUS. IN THE LONG RUN, LESS IS MORE.

In our model, the single biggest driver of profitability is practice area concentration. Similar to the geographic concentration metric, we measure practice area concentration through a methodology akin to the Herfindahl

A FEW MAIN PRACTICES—OR MANY?

These Am Law 200 firms have the highest and lowest scores for practice-area concentration. Firms with green bars have most lawyers focused on one or a few select practices.

Law Firm	Highest Practice Concentration (Top 20)
Knobbe Martens	
Cravath	
Finnegan	
Simpson Thacher	
Munger Tolles	
Fish	
Willkie	
Shook Hardy	
Wachtell	
Kasowitz	
Gibbons	
Fried Frank	
Jackson Lewis	
Debevoise	
Davis Polk	
Shearman & Sterling	
Wilmer	
Weil Gotshal	
Cadwalader	
Akerman	
	Lowest Practice Concentration (Bottom 20)
Husch Blackwell	
Barnes & Thornburg	
Foley Hoag	
Davis Wright	
Stinson Leonard	
Jeffer Mangels	
Holland & Hart	
Shumaker	
Vedder Price	
Dickinson Wright	
Lane Powell	
Loeb & Loeb	
Ice Miller	
Brownstein	
Fox Rothschild	
Day Pitney	
Sheppard Mullin	
Bond	
Michael Best	
Burr & Forman	

Lowest = 0 | 0.50 | Highest = 1

Practice Concentration Score

Index used in antitrust assessments. Using data from ALM's RivalEdge database, we grouped lawyers into 12 general practice categories. Firms with an even distribution of lawyers across all 12 practices areas get a score of zero. Firms with a single firmwide practice get a 1. For the most and least concentrated firms in terms of practice areas, see the chart at left.

As our first chart shows, the high-scoring, focused firms are walking away with the cash. On one level, this strategy's effectiveness should be obvious. By doing fewer things, we do those things better. The best restaurants offer a limited menu and consistently spectacular service. Apple revolutionized the computer industry by slashing product lines and devoting itself to building a handful of products that were much better than their competitors'—and crucially, the judgment of "better" was through the eyes of the customer rather than the engineer (read: lawyer).

In the past, we have linked the power of Steve Jobs' focus principle to the world of law firm strategy ["How to Take Market Share," October 2015]. In truth, it is nothing more than a variation on one of the most quoted strategy maxims of all time: "The essence of strategy is deciding what not to do." [Michael Porter, "What Is Strategy," Harvard Business Review, November 1996].

All businesses struggle with this maxim because it requires making difficult choices. It's arguably harder for law firms because the partnership structure spreads decisions over myriad partners with divergent interests.

Focus is also harder for firms because until recently it wasn't a required part of their business models. The Am Law 200 is composed of firms that, as recently as 10 years ago, were regional or local oligarchs who divided up lucrative clients in their area with a few other general service competitors.

Yet as these firms have grown into one another's backyards, a highly competitive national market has emerged. Our results suggest that one way these firms can regain market power is by applying the focus principle. As with geography, it is not so much about what they focus on but that they focus on something.

SUMMARY

Lawyers often misconstrue the imperative of making difficult strategic trade-offs as a choice between money and culture. The core question is in fact more of an existential one: Do we have a plan that enables us to keep and grow market share? If the answer is no, the firm itself might not survive much longer than the death or retirement of its most powerful partners.

The five strategies we've laid out deserve your attention. Our model explains about 80 percent of the variation of average partner compensation. Stated another way, you'd be a fool to bet against our conclusions.

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METHODOLOGY

For this analysis we used ALM's average partner compensation, from The American Lawyer's 2016 Am Law 200 (using data from 2015). We use this outcome because profits per equity partner (PPP) can be increased by a relatively arbitrary classification that is hidden from the external world. A more reliable measure of financial performance is the average compensation of all lawyers who share the partner title, whether equity or non-equity. We use log transformations of the average partner compensation metric, standard practice in labor economics. This is because the logged version corrects for the shrinking marginal effects of large gains in income and produces a better-fitting model.

The practice area predictors are derived from ALM's RivalEdge data and rely on lawyer counts by practice, as opposed to the percentage of lawyers by practice. We do this because firm size is also a predictor in the model, not only because it is of strategic interest, but because it normalizes attorney counts for firms' specific practices.

To get greater resolution on the importance of financial services practices, we also incorporated firm ratings produced by the International Financial Law Review (IFLR), which focuses exclusively on the world of finance.

IFLR ranks firms on fourteen areas of financial service practice. (We scored firms that were not ranked by IFLR as 0s in the raw data.) We reduced the 14 ratings to three general metrics—Investment Banking, Financial Workouts, and Hedge Funds/Private Equity—using a data reduction technique known as factor analysis.

The predictors related to concentration—geographic, practice area, and industry—were constructed using a Herfindahl Index. Of these metrics, we have the least confidence in the industry concentration predictor, since it is derived from simple counts of representation of Fortune 500 companies (which we classified into 13 industry categories); the IFLR predictors, which measure financial industry focus, are extremely powerful; and some general practice area predictors are in effect industry concentrations, such as real estate and construction). We suspect that a better industry concentration measure would produce stronger positive results, because focus seems likely to improve a firm's performance over the long term.