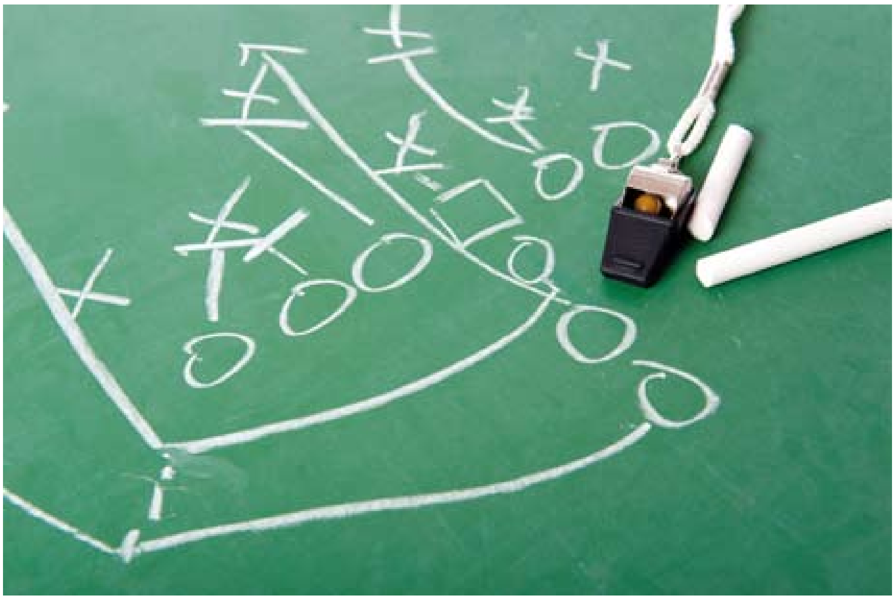
GAME PLAN

EDITORIAL BOARD MEMBER ANDREW HEDLEY REVEALS HOW LAW FIRMS CAN REVISE THEIR FINANCIAL STRATEGIES TO SUPPORT ALTERNATIVE FEE ARRANGEMENTS

FOUR THINGS YOU WILL LEARN FROM THIS MASTERCLASS:

1. Why some firms are able to offer more competitive pricing than others
2. How an inside-out approach to pricing is insufficient on its own
3. How competitor analysis can significantly increase profits from alternative fee arrangements
4. How market-based pricing can increase the perceived value of client services



Alternative fee arrangements are here to stay. A combination of increased competitive sophistication and recession economics mean that clients of all hues are increasingly unwilling to pay their lawyers on the basis of hourly charges.

Client demand means that legal services must be delivered better, faster and cheaper. Firms must enhance delivery, increase transparency, provide fee certainty and, importantly, a reduction in overall spend year-on-year if they are to prosper.

In order to compete across a broad spectrum of legal services, firms will need to develop a menu of alternative fee arrangements.

To achieve this, they will need a much better understanding of their internal economics and operational models. They will also need to make more active choices about which markets to compete in (where they can create a relative competitive advantage) and which to walk away from. This can only be done with better market and competitor intelligence to shape strategy and a ruthless focus on excellence in implementation.

At the core of any approach adopted to address these competitive challenges is a different way of working. The role of the partner will change quite fundamentally in those firms seeking to capitalise on the opportunities offered by a rapidly changing landscape. This new role will centre on dealing with only the most difficult legal issues, excelling in project management, devoting significant time to client relationship development and investing in team leadership skills.

There will, of course, be a small number of successful firms that operate on a traditional model, but these will be exceptions and confined to specialist, high added-value niche practices in which the majority of the work requires partner input. Most law firms will need to operate on a fundamentally different model if partners are to continue to enjoy the levels of profits to which they have become accustomed.

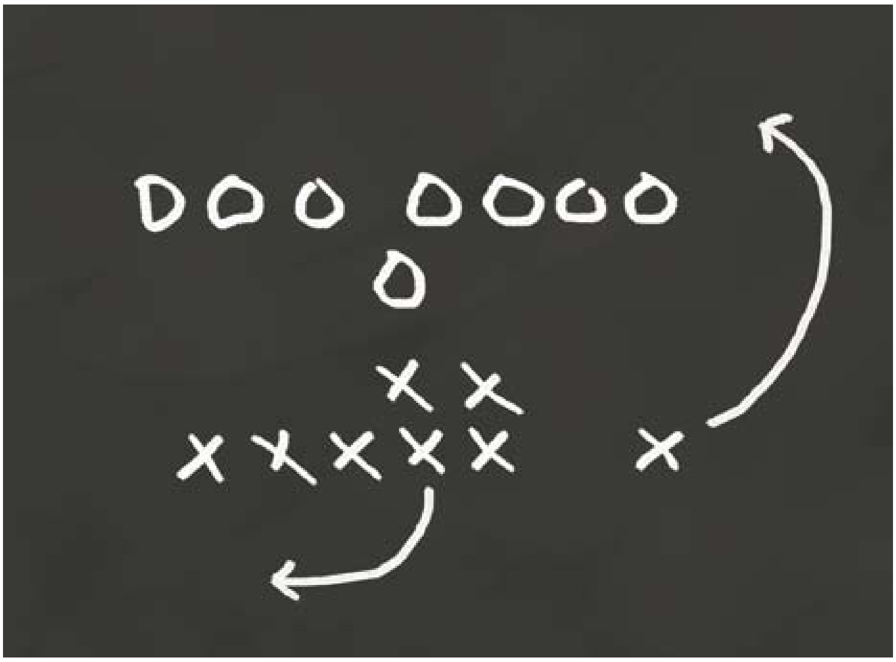
Historic price setting

To put the challenge created by alternative fee arrangements into context, we first need to review historic approaches to price setting under the hourly rate model, which passes any internal cost increases directly to the client, with the margin being preserved.

In many firms, discussions about the annual rate rise were led by the finance team and were grounded in cost projections and desired margins in order to arrive at hourly rates. Business development strategy was at the margin, likely market volumes were not considered and the impact of competitor strategies received only cursory attention, other than to check that the firm remained in the expected banding. To a large extent, the firm was in control of the price and the client had to take what was offered.

A business environment of this nature will often lead to a 'going rate' approach to pricing in which everyone competes, but not too much.

While such strategies may work in benign and buoyant markets, they founder in situations of overcapacity or when aggressive firms set out to capture increased market share. This is the environment that we now face.



Expanding options

Against the backdrop of current market conditions, it is unsurprising that other more aggressive and creative options (some of which pre-date the recession and others which have had their genesis within it) have come to the fore at an accelerating pace.

Those now on general offer are numerous and the term 'alternative fee arrangement' has come to cover a very broad church. For example, consider just some of the new vocabulary used in the legal sector to describe charging methods – fixed fee, lump sum fee, capped fee, value account, blended rate, contingency fee, tiered discount, equity share, retainer and success fee. All are examples of how firms have responded to client and competitive pressures.

Leading edge businesses now set out their stall almost entirely on the basis of a menu approach. Research shows that this sharing of risk and the alignment of commercial success with law firm reward is compelling from the viewpoint of the client.

These new approaches also share one less attractive feature in common – get the calculation wrong and the commercial impact will hurt! So, what processes can be put in place to increase the probability of getting the fee level correct in a world where risk has shifted sharply from client to lawyer?

By way of example, consider the exercise of creating a fixed-fee offer to illustrate the strategic questions to be considered if a firm is to write a profitable book of business while at the same time ensuring high levels of client satisfaction.

Inside-out approach

Firms generally adopt what I term an inside-out approach to deciding the levels at which to fix their fees for a particular category of work.

The starting point will typically be an analysis of actual time records of how much this work has cost the firm in the past. Consequently, it seems that regardless of external factors, a notional hourly rate for a particular level of lawyer will remain the internal measure of choice for the foreseeable future. Such an analysis is, of course, predicated on the fact that such time recording records are accurate.

The analysis should consider quantum costs but also, importantly, the team structure in terms of gearing and management. The objective is not simply to understand the costs of such work historically but also what 'good' looks like by evaluating the approach of those teams which have operated most cost effectively. Can this structure be modelled and used as a template more widely in the business?

Analysis of this nature will get us to the point of understanding past performance but it does not necessarily give us a clear perspective on what might be possible. The question that needs to be asked is not 'how cost effectively can we do this?' but rather 'how cost-effectively can this be done?'

The two are quite different issues. Many managing partners protest that competitor firms are low-balling to win fixed-fee work, but just because they can't do the work profitably at that fee level, it doesn't mean the work can't be done profitably by someone else at that level.

This leads to a consideration of how a new template might allow the work to be approached differently and more cheaply without compromising the end result for the client (but with the firm being prepared to be flexible as to the means which are employed to meet that end goal).

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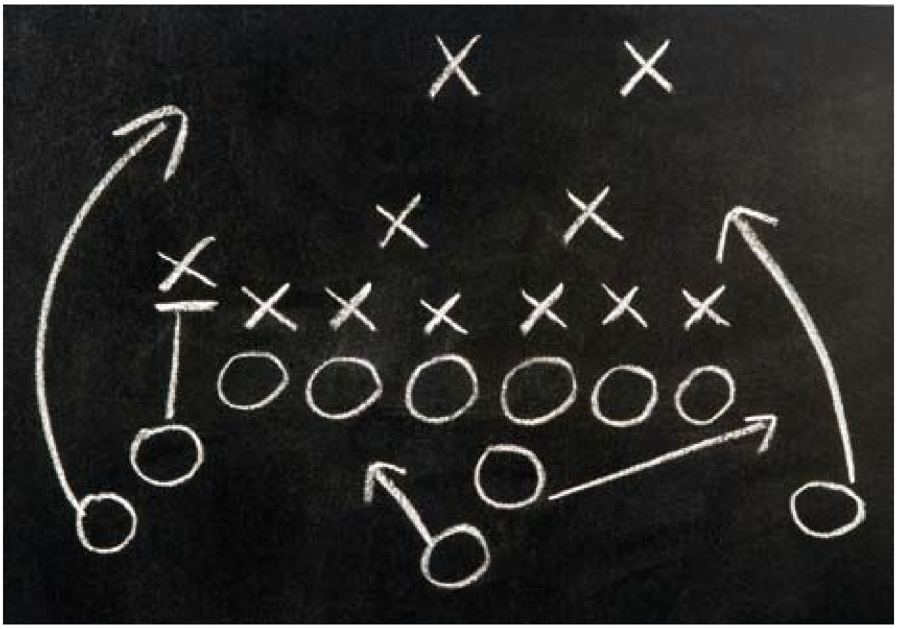
The options are varied and strategy group brainstorming will often elicit a range of possibilities, each with their own set of challenges and potential rewards.

The more radical firm will look at fundamental re-engineering of its business processes; perhaps outsourcing certain elements, disaggregating the value chain of the service and ensuring



that each component is engineered to be delivered at the correct quality and lowest cost.

Other firms will take a more evolutionary approach and gradually change the shape of their operating models through a number of incremental steps to improve the efficiency of processes and reduce their costs base.

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It remains the case, though, that the inside-out perspective is fundamentally a cost-based approach to pricing. Whilst huge efficiencies may be achieved, the ultimate offer price is derived from a consideration of the cost of doing the required tasks plus a profit margin that is deemed acceptable to the firm with an eye on market conditions.

In the new paradigm of the fixed price world, any increase in costs (if not matched by increased volumes of business) will simply impact on margin.

Inside-out is necessary but not sufficient.

Outside-in perspective

In the past, few firms adopted a market-based approach by taking an outside-in perspective. What is relevant in market-based pricing is not the current cost of production but rather the perceived value of the service when set alongside other similar or alternative offers.

Pricing theory tells us that success in such an approach depends on an accurate analysis of the market and a deep understanding of client requirements. These theoretical signposts should figure high in the minds of senior management faced with designing their firms' service delivery in order to make profits at a fixed price point.

The first challenge is to establish what the appropriate price point is; few law firms have anything other than an anecdotal assessment of the pricing approach of their competitors. Even a small improvement in this knowledge could lead to significant pricing advantages.

The second aspect of an outside-in approach is to carefully analyse those elements of the fixed price service that are valued highly by the client and those which could be reduced or eliminated altogether. What this means in practice is that the management team will have to develop the ability to adjust service levels to reflect fee ceilings. The key measure is the fitness for purpose of the service. Outside the legal service industry, one would not expect the same levels of service or quality from a premium product as from an economy model. Firms will increasingly differentiate their own services in a similar way.

There are also a number of misconceptions when market-based pricing is debated. The view often expressed is that such an approach will inexorably lead to margins coming under fire. It is fair to say that this is likely to be the case for services which are mature, with stiff competition and a wide choice for clients.

However, user adoption and product lifecycle theories also show that, at the innovation stage, a market-based approach can significantly increase profits through skimming-based pricing strategies.

Future prospects

We should never forget that law firms are still in a happy position compared to many other industries (no matter how much it doesn't feel that way!) Even after the October 2011 introduction of alternative business structures in the UK under the Legal Services Act, legal services will continue to be relatively highly regulated. They are also rarely a discretionary purchase, particularly within a commercial context.

The competitive question is, which firm will secure the work and on what basis? With supply exceeding demand, an outside-in, market-based approach to pricing and service delivery will continue to drive change.

This has profound implications for firms at both strategic and operational levels. Those able to effect structural change with have the advantage from a cost base perspective. Enduring competition will mean that service development through innovation will be crucial. Success will flow to those able to combine the two and take advantage of market opportunities through premium pricing of new products as well as being operationally excellent in order to eke out profits throughout the service lifecycle. mp

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