The Big Picture Revealed by the Am Law 100 Results

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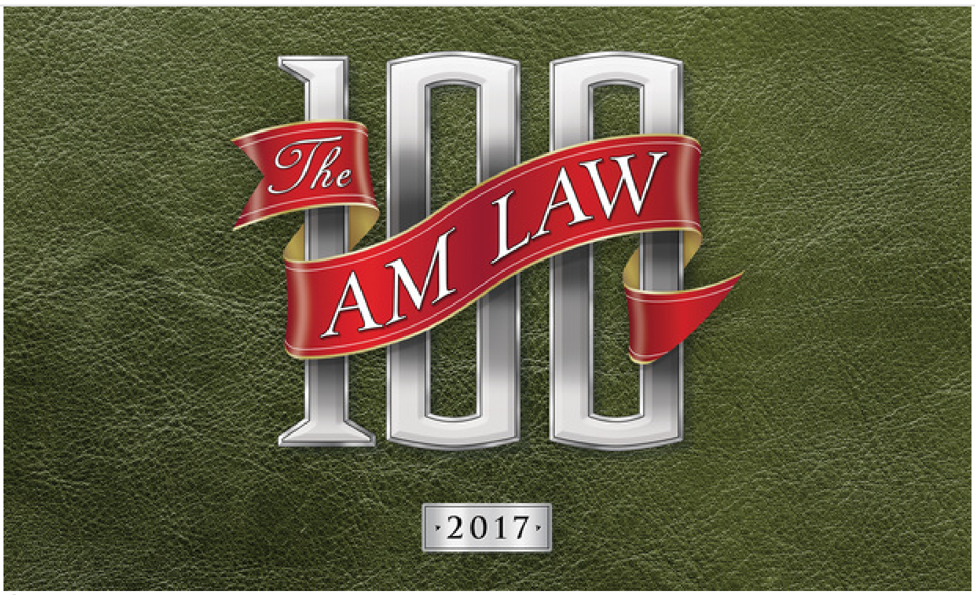


Credit: ALM

There has been a lot written already about the winners and losers in the Am Law 100 results for 2016—virtually all of it focused on changes since the prior year. But what's the big picture? Do the results reveal long-term trends and, if so, how will continuation of these trends transform big law? Here's our take.

Since 2008, and probably before, a small group of approximately 20 firms has been widening its lead over all other firms and concentrating its share of Am Law 100 profits. For now, there are over a dozen firms in a mid-tier between the leaders and a lower tier of the remaining Am Law 100 firms. Over time, though, the mid-tier is becoming emptier as some mid-tier firms join the leaders and most fall into the lower tier. A wider gap is opening between leaders and the rest.

This result is not surprising. It reflects the predictable and inexorable evolution of the legal industry in the United States, in line with the experience of other service industries such as accounting and management consulting where the largest firms capture the lion's share of the most lucrative work. The U.K. legal industry has already gone through this process. By 2010, five Magic Circle firms had emerged from the pack, each with net income that far exceeded that of competitors. Those firms remain dominant today, while their competitors scramble to catch up, often by merging.

So if the U.S. market for legal services is concentrating in the same way—and we think it is—what can the Am Law 100 results tell us about who is winning and who is not?

Size and growth of net income are better measures of success than PPEP

Many commentators use profit per equity partner (PPEP) or even revenue as the key metric of law firm success. We believe that growth of net income—what we call "profit pool" and what the Am Law 100 data calls "net operating income"—is a good measure of success. This measure allows analysts to track productivity improvement—increasing profits with the same number of equity partners—as well as increased size—the capacity to take on more market share by expansion of productive units, such as by an increased number of equity partners. Both types of growth are important. Also, absolute size matters, though of course it's not a substitute for the disciplines of success (see sidebar).

> **Why Size Matters**
> *Size is not a substitute for the disciplines of success but having a bigger profit pool certainly helps. Firms with more to spend can, among other things:*
>
> • compete with broader or deeper practice offerings,
> • reduce dependency on individuals,
> • pay more for highly productive talent,
> • benefit from economies of scale in technology and other efficiency-enhancing infrastructure, and
> • better withstand outside risk events such as last year's associate salary hike or an economic downturn.
>
> Firms whose profit pools fall too far behind the leaders, can continue to thrive, but over time will struggle to offer the range of valuable legal services of the leaders and are likely to become less competitive. A transformative merger can vault a firm from the lower competitive tier to mid-tier, or even into the leading tier, but can the firm stay there? Large mergers are infrequent, not least because they are challenging to consummate unless at least one of the merging firms is weak. In order to continue to grow the profit pool, the combining firms also need to improve productivity, an imperative that is often overlooked in the wake of a major merger.

Growth over the long term, not merely a one- or two-year spike, typically reflects a growing, sustainable business. That's what really counts.

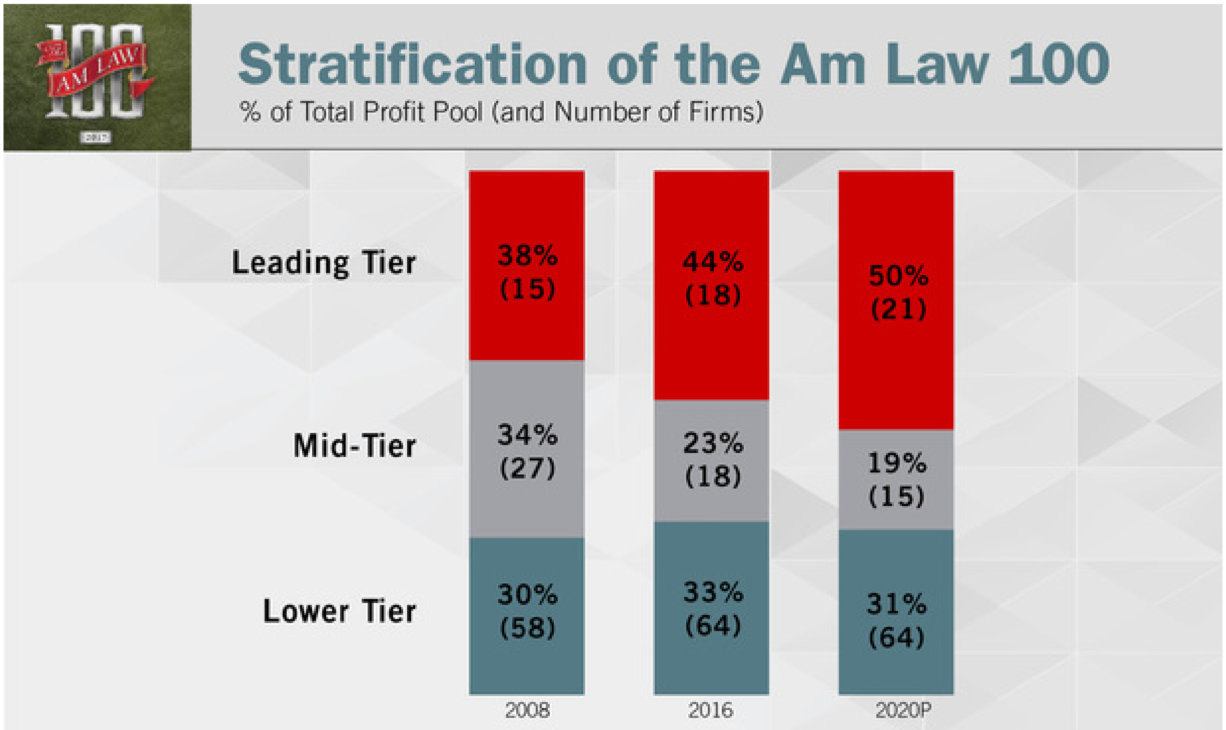
PPEP growth is less useful for analyzing long-term performance because it doesn't necessarily reflect increases in a firm's productive capacity. In fact, many firms have steadily increased PPEP while shrinking partner head count. Eliminating less productive equity partners may be smart for many reasons. Yet unless the firm replaces those equity partners, and ideally adds more, it will eventually experience a declining profit pool and a steadily less competitive platform as other firms grow larger.

Trends in the Am Law 100 since 2008

We therefore concentrate on longer term performance. For this article, we look at results over the eight years from the 2008 recession to 2016. The accompanying chart outlines our findings. For illustration, the chart also includes projected results for 2020, showing the trajectory of firms based on past growth rates. We find:

• Profits are concentrating in a few firms.

Profits of the Am Law 100 are increasingly concentrating in a small tier of leading firms with the largest profit pools, ranging from $550 million to $1.47 billion. The bands established to delineate the boundaries between the tiers are arbitrary, but they reflect wide gaps between each tier of firms and the next that act as a "natural" dividing line. In 2016, there were 18 firms in the leading tier, together representing 44 percent of the total profit pool of Am Law 100 firms, up from 36 percent in 2008. By 2020 profits are projected to be further concentrated in the leading tier at 50 percent.



• Once on top, leading firms stay ahead.

Once a firm has attained the leading tier it tends to remain. Sheer size creates leeway for these leading firms to have a few years of lower growth and still retain their leading position. Only four of the 15 leading firms in 2008 had dropped out of the tier by 2016. Three of those four firms fell out even though their profit pools grew in line with the Am Law 100. For too many years their growth didn't keep up with faster growing peers in the leading tier or entering it. Seven new firms joined the tier, several by growing through significant mergers.

• There are many routes to the top.

Firms in the leading tier grew their profit pools through a variety of strategies. Some have pursued broad practice offerings; others focused on growing a deep bench in a handful of practice areas. In pursuing these strategies, leading firms captured increased profit either through productivity gains or capacity increases by adding equity partners (internal promotion, laterals, mergers), or both.

• The mid-tier is emptying to become a sparsely populated band of firms whose profit pools in 2016 ranged from approximately $350 to $550 million.

As the Am Law 100 stratifies, the mid-tier is emptying. In 2008 there were 27 firms in the mid-tier, but only 18 firms by 2016. As a percentage of total Am Law 100 profits, the mid-tier shrank from 34 percent to 23 percent. On current trends, we project it to shrink further, to 19 percent of profits and 15 firms by 2020.

• The lower tier is growing, as more firms drop from the mid-tier.

As the mid-tier firms fall to the lower tier, it becomes larger. In 2016, the 64

Leading Am Law 100 Firms

The 18 firms in the leading tier in 2016 – those with the largest profit pools – were (in descending order of profit pool):

1 Kirkland & Ellis ($1.471 billion)
2 Latham & Watkins
3 Skadden Arps
4 Gibson Dunn
5 Jones Day
6 Baker & McKenzie
7 Morgan Lewis
8 Quinn Emanuel
9 Sidley Austin
10 Sullivan & Cromwell
11 Hogan Lovells
12 Simpson Thacher
13 DLA Piper
14 Cleary Gottlieb
15 White & Case
16 Paul Weiss
17 Davis Polk
18 Ropes & Gray ($571 million)

Mid-Tier Am Law 100 Firms

The 18 firms in the mid-tier in 2016 were (in descending order of profit pool):

1 Norton Rose Fulbright ($529 million)
2 Wilmer Hale
3 Weil Gotshal
4 Paul Hastings
5 King & Spalding
6 Greenberg Traurig
7 Wachtell
8 Milbank
9 Baker Botts
10 Mayer Brown
11 Akin Gump
12 Goodwin Procter
13 Dechert
14 Cooley
15 Proskauer
16 Covington
17 Willkie Farr
18 Cravath ($365 million)

firms with the smallest profit pools (up to $350 million) represented 33 percent of total Am Law 100 profits, up from 58 firms with 30 percent in 2008. These firms have no realistic prospect, absent a transformative merger, of reaching the leading tier—a profit pool gulf of more than $200 million. These firms are generally not in financial trouble, but competitive pressure is steadily building because of their inability to match the leaders.

• Individual success is possible in any tier.

Being in a particular tier does not control a firm's results in any particular year, as a PPEP comparison will show. Also the rate of growth in profit pool is not an indicator of sustained success. Each of the three tiers includes firms that have grown their profit pools extremely well for several years (7 percent or more annual growth). Record performance for firms in the mid-tier or lower tier may be satisfying, but without a change in competitive standing, good performance is neither an indicator of long-term health nor of a winning trajectory.

• While equity partner growth stalled in the Am Law 100, many leading firms grew their EP ranks.

Net growth in equity partners for the Am Law 100 collectively approached zero from 2008 to 2016. The number of equity partners in the Am Law 100 grew at a 21 percent annual rate in the six years before 2008, but only at 1 percent annually from 2008 to 2016. In contrast, seven of the 18 firms in the leading tier derived more than 20 percent of their 2016 profit pool increase by adding equity partners, including through laterals and mergers. The near halt in equity partner growth for the most part reflected firms' removing or de-equitizing less productive partners. Nonequity partners grew at 9 percent annually during the six years before 2008, and continued at 5 percent annually through 2016.

• Most mergers involved an obviously weaker firm, revealing the imperative for the stronger firm to grow.

In most sizable law firm mergers in recent years, one of the merging parties had dramatically weaker performance. This is an early sign of how difficult it is for firms to grow their share of Am Law 100 profits and the pressure they feel to take action notwithstanding the potential dilution in PPEP from merging with a weak firm seeking a white knight.

• Merger activity will increase.

We expect pressures to pursue mergers (including acquisitions of practice groups) to increase in 2017, because the many firms that are falling behind are under increasing pressure to grow. The lateral market will also remain active. Firms will remain under pressure to improve productivity of their laterals.

Conclusion

The overall trend of concentration of Am Law 100 profits in a leading tier of firms appears to be following the pattern of other professional service industries.

The good news for many firms is that the trend is slow compared to other industries. There is opportunity for great performance by firms, and rich reward to their partners, in each of the three tiers. Firms in the mid-tier and lower tier—even those with very good performance—do need to be mindful as they set their strategies, of the additional and growing risks they face from steadily losing competitiveness over time.

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