

*Legal Marketing Association
Bay Area Chapter*

*Fundamentals of Law Firm Finance
for
Marketing Professionals*

February 27, 2007

Two general views of law firm finance

- ◆ *Public*
- ◆ *Private*

- ◆ *You should understand both.*
- ◆ *Note: They're related, of course.*

Two general views of law firm finance

◆ Public

→ Lists

- AmLaw 200, NLJ 250
- Cal 25 (see next slide, Bay Area firms)

→ Factors

- Revenue
- RPL
- PPP

Fundamentals of Law Firm Finance

| | <u>Revenue (\$MM)</u> | <u>RPL (\$000)</u> | <u>PPP (\$000)</u> |
|------------------|-----------------------|--------------------|--------------------|
| <i>Townsend</i> | 170.5 | 940.0 | 1,440.0 |
| <i>Heller</i> | 507.0 | 845.0 | 1,035.0 |
| <i>Bingham</i> | 686.0 | 830.0 | 1,220.0 |
| <i>MoFo</i> | 774.0 | 820.0 | 1,130.0 |
| <i>Orrick</i> | 666.0 | 795.0 | 1,430.0 |
| <i>Wilson</i> | 460.0 | 790.0 | 1,275.0 |
| <i>Cooley</i> | 335.0 | 770.0 | 1,000.0 |
| <i>Pillsbury</i> | 579.5 | 770.0 | 875.0 |
| <i>Fenwick</i> | 167.0 | 710.0 | 940.0 |
| <i>Thelen</i> | 241.5 | 665.0 | 850.0 |
| <i>Little</i> | 240.0 | 540.0 | 465.0 |
| <i>Sedgwick</i> | 172.0 | 470.0 | 705.0 |

Two general views of law firm finance

◆ Private

→ *Balance sheet*

- *Assets*
- *Liabilities*

→ *P&L*

- *Revenues*
- *Expenses*
- *Net income*

*As we discuss law firm finance today,
keep one thing in mind:*

- ◆ *Law firms are cash basis enterprises*
 - *Revenues are based on cash collections*
 - *Expenses are incurred when paid*

- ◆ *Most real-world businesses are accrual basis enterprises*
 - *Revenues are realized at time of sale*
 - *Expenses are taken when obligation incurred*

What this means:

CASH IS KING!!!

This portion of today's presentation . . .

- ◆ *Profitability – what it is, why it's important & what drives it*
- ◆ *Revenue factors – hours, rates, realization*
- ◆ *Expense components – people, facilities, administration & other*
- ◆ *Financial analysis – how various factors impact profitability*

Profitability – what is it?

- ◆ *Revenue, less*
- ◆ *Expenses, equals*

- ◆ *Net income*

Profitability – why is it important?

- ◆ *Partner income*

- ◆ *Note: AmLaw 200 profits are high, but profits must fund 100% of partners' . . .*
 - *current income*
 - *current benefits*
 - *retirement income*
 - *retirement benefits*

Profitability – why is it important?

- ◆ *External audiences, e.g., AmLaw 200, NLJ 250*
 - *Reputation in professional community*
 - *Attorney recruitment, both partners & associates*

Profitability – why is it important?

- ◆ *Internal audiences*
 - *Firm stability*
 - *Attract & retain outstanding lawyers*
 - *Morale*

Profitability – why is it important?

- ◆ *Investment capital*
 - *Practice expansion*
 - *Client service*
 - *Technology, e.g., knowledge management*

Profitability – is it important to clients?

- ◆ *Most businesses want their vendors & service providers to be not only cost-competitive but also reliable & effective*
- ◆ *Clients should want the firms they work with to be profitable enough to . . .*
 - *attract & retain the best lawyers*
 - *provide the highest level of client service*

 - *except when the firm's work is perceived is a commodity service, in which case an entirely different set of principles applies*

What drives profitability?

- ◆ *Revenue*
- ◆ *Expenses*

- ◆ *Note: Here, we're talking about profitability in an absolute sense, not NIPP or PPP, which is driven by partnership structure*

What drives expenses?

- ◆ *People – salaries & benefits (~65%)*
- ◆ *Facilities – rent, depreciation, tech leases (~15%)*
- ◆ *Other, e.g., E&O insurance & claims, marketing, recruitment, training, communications, etc. (~20%)*

Fundamentals of Law Firm Finance

| | <u>Amount (\$MM)</u> | <u>Percentage</u> |
|------------------------|----------------------|-------------------|
| <i>Revenue</i> | \$450.0 | |
| <i>Expenses</i> | | |
| <i>Employment</i> | 195.0 | 65.0% |
| <i>Facilities</i> | 45.0 | 15.0% |
| <i>Other</i> | 60.0 | 20.0% |
| | ----- | ----- |
| <i>Total expenses</i> | 300.0 | 100.0% |
| | ----- | |
| <i>Net income</i> | \$150.0 | |
| <i>No. of partners</i> | 200 | |
| <i>PPP</i> | \$750,000 | |

One thing to remember about expenses – and, therefore, about profitability . . .

- ◆ *Except for compensation, expenses per lawyer (EPL) are comparable at well-managed firms of similar size in similar locations*
- ◆ *With EPL comparable at most firms, revenue (specifically, revenue per lawyer, or RPL) drives differences in profitability from firm to firm*
 - *and so does partnership structure!*

Fundamentals of Law Firm Finance

| | <u>Revenue (\$MM)</u> | <u>RPL (\$000)</u> | <u>PPP (\$000)</u> |
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So what drives revenue?

- ◆ *In the billable hour model . . .*
 - *hours*
 - *rates*
 - *realization*
 - *billing*
 - *collections*
- ◆ *Non-discount alternative fee arrangements sidestep hours & rates*

How do these factors affect a hypothetical AmLaw 200 firm?

- ◆ *The hypothetical firm (BASE CASE)*
 - *600 lawyers*
 - *1800 hours = 1,080,000 total hours, times*
 - *\$463/hr average billing rate = \$500 million, times*
 - *90% all-in realization = \$450 million revenue, less*
 - *\$300 million in costs = \$150 million profit, divided by*
 - *200 equity partners = \$750,000 full-equity NIPP*

Fundamentals of Law Firm Finance

| | <u>Base Case</u> | <i>Hrs + 100</i> | <i>Rate + \$20</i> |
|-----------------------------|------------------|------------------|--------------------|
| <i>No. of lawyers</i> | 600 | 600 | 600 |
| <i>Hrs/lawyer</i> | 1800 | 1900 | 1800 |
| <i>Total hrs</i> | 1,080,000 | 1,140,000 | 1,080,000 |
| <i>Aver billing rate</i> | \$463/hr | \$463/hr | \$483/hr |
| <i>Subtotal (\$MM)</i> | 500.0 | 527.8 | 521.6 |
| <i>All-in realization %</i> | 90% | 90% | 90% |
| <i>Revenue (\$MM)</i> | 450.0 | 475.0 | 469.4 |
| <i>Costs (\$MM)</i> | 300.0 | 300.0 | 300.0 |
| <i>Net profit (\$MM)</i> | 150.0 | 175.0 | 169.4 |
| <i>No. of partners</i> | 200 | 200 | 200 |
| <i>Full-equity NIPP</i> | \$750,000 | \$875,000 | \$847,000 |

Let's raise hours to 1900 (6%)

- ◆ *The hypothetical firm*
 - *600 lawyers*
 - *1900 hours = 1,140,000 total hours, times*
 - *\$463/hr average billing rate = \$527.8 million, times*
 - *90% all-in realization = \$475 million revenue, less*
 - *\$300 million in costs = \$175 million profit, divided by*
 - *200 equity partners = \$875,000 full-equity NIPP*
- ◆ *So a 6% increase in hours leads to a 17% increase in NIPP*

Fundamentals of Law Firm Finance

| | <i>Base Case</i> | <i><u>Hrs + 100</u></i> | <i>Rate + \$20</i> |
|-----------------------------|------------------|-------------------------|--------------------|
| <i>No. of lawyers</i> | 600 | 600 | 600 |
| <i>Hrs/lawyer</i> | 1800 | 1900 | 1800 |
| <i>Total hrs</i> | 1,080,000 | 1,140,000 | 1,080,000 |
| <i>Aver billing rate</i> | \$463/hr | \$463/hr | \$483/hr |
| <i>Subtotal (\$MM)</i> | 500.0 | 527.8 | 521.6 |
| <i>All-in realization %</i> | 90% | 90% | 90% |
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| <i>Costs (\$MM)</i> | 300.0 | 300.0 | 300.0 |
| <i>Net profit (\$MM)</i> | 150.0 | 175.0 | 169.4 |
| <i>No. of partners</i> | 200 | 200 | 200 |
| <i>Full-equity NIPP</i> | \$750,000 | \$875,000 | \$847,000 |

Or raise rates \$20/hr (4%) across board

- ◆ *The hypothetical firm*
 - *600 lawyers*
 - *1800 hours = 1,080,000 total hours, times*
 - *\$483/hr average billing rate = \$521.6 million, times*
 - *90% all-in realization = \$469.4 million revenue, less*
 - *\$300 million in costs = \$169.4 million profit, divided by*
 - *200 equity partners = \$847,000 full-equity NIPP*
- ◆ *So a 4% increase in billing rates leads to a 13% increase in NIPP*

Fundamentals of Law Firm Finance

| | <i>Base Case</i> | <i>Hrs + 100</i> | <u><i>Rate + \$20</i></u> |
|-----------------------------|------------------|------------------|---------------------------|
| <i>No. of lawyers</i> | 600 | 600 | 600 |
| <i>Hrs/lawyer</i> | 1800 | 1900 | 1800 |
| <i>Total hrs</i> | 1,080,000 | 1,140,000 | 1,080,000 |
| <i>Aver billing rate</i> | \$463/hr | \$463/hr | \$483/hr |
| <i>Subtotal (\$MM)</i> | 500.0 | 527.8 | 521.6 |
| <i>All-in realization %</i> | 90% | 90% | 90% |
| <i>Revenue (\$MM)</i> | 450.0 | 475.0 | 469.4 |
| <i>Costs (\$MM)</i> | 300.0 | 300.0 | 300.0 |
| <i>Net profit (\$MM)</i> | 150.0 | 175.0 | 169.4 |
| <i>No. of partners</i> | 200 | 200 | 200 |
| <i>Full-equity NIPP</i> | \$750,000 | \$875,000 | \$847,000 |

Or take base case & de-equitize 50 partners

- ◆ *De-equitization increases costs by, say, \$400,000 per de-equitized partner, or \$20 million*
- ◆ *The hypothetical firm*
 - *600 lawyers*
 - *1800 hours = 1,080,000 total hours, times*
 - *\$463/hr average billing rate = \$500 million, times*
 - *90% all-in realization = \$450 million revenue, less*
 - *\$320 million in costs = \$130 million profit, divided by*
 - *150 equity partners = \$867,000 full-equity NIPP*

Fundamentals of Law Firm Finance

| | <i>Base Case</i> | <u><i>De-equitize 50</i></u> |
|-----------------------------|------------------|------------------------------|
| <i>No. of lawyers</i> | 600 | 600 |
| <i>Hrs/lawyer</i> | 1800 | 1800 |
| <i>Total hrs</i> | 1,080,000 | 1,080,000 |
| <i>Aver billing rate</i> | \$463/hr | \$463/hr |
| <i>Subtotal (\$MM)</i> | 500.0 | 500.0 |
| <i>All-in realization %</i> | 90% | 90% |
| <i>Revenue (\$MM)</i> | 450.0 | 450.0 |
| <i>Costs (\$MM)</i> | 300.0 | 320.0 |
| <i>Net profit (\$MM)</i> | 150.0 | 130.0 |
| <i>No. of partners</i> | 200 | 150 |
| <i>Full-equity NIPP</i> | \$750,000 | \$867,000 |

Fundamentals of Law Firm Finance

Law firm finance – lessons learned

- ◆ *Law firms are cash basis enterprises*
 - *CASH IS KING!*
- ◆ *Except for compensation, expenses per lawyer (EPL) are comparable at well-managed firms of similar size in similar locations*
- ◆ *With EPL comparable at most firms, revenue (specifically, revenue per lawyer, or RPL) drives differences in profitability from firm to firm*
 - *and so does partnership structure!*
- ◆ *In the billable hour model, revenues are a function of*
 - *hours*
 - *rates*
 - *realization*