It all adds up

*Despite the sombre headlines of financial woe we were faced with last year, 2013 saw the UK economy grow and the professional services sector perform strongly. Can they both be right? **Barry Wilkinson** looks at what exactly is going on*

These are confusing times for anyone who follows the fortunes of the legal sector. On the one hand, the Solicitors Regulation Authority (SRA) and other commentators have expressed concern about the financial stability of the market, and the impending demise of up to 2,000 firms is widely predicted. On the other, statistics show that the UK economy is growing, with the professional services sector performing strongly in 2013. Can both be correct? Or was Mark Twain right when he spoke of “lies, damned lies, and statistics”?

Detailed analysis of the professional services sector uncovers several distinct and sometimes conflicting trends affecting the legal market. I will explain how – and how much – different segments of the market are affected by each of these trends.

This can be a dangerous time for businesses weakened by the recession, as much of the legal sector undoubtedly was. Economists and insolvency practitioners have demonstrated that, in the last 100 years, insolvencies have peaked in the early stages of the upturn in the business cycle. This is because businesses use up their resources in surviving a downturn, and do not have the funding available to grow again. They are, in effect, ‘overtrading’. This is a particularly difficult issue in the legal sector because of the long ‘lock-up’ periods that firms have been accustomed to, making growth in many legal disciplines reliant on a steady cash flow.

Several surveys of different parts of the legal market have been produced by leading accountancy firms in recent months, including the Law Management Section (LMS) Financial Benchmarking Survey, analysed by Hazelwoods. This shows a consistent pattern of modest increases in average turnover and profit in law firms. However, closer analysis indicates that there is an increasing divergence in the fortunes of those surveyed. The successful firms are getting steadily stronger, and the weaker ones continuing to struggle. The PricewaterhouseCooper (PwC) survey, which covers the top-100 firms, indicates quite clearly that financial difficulties are not confined to smaller firms.

However, all of these surveys are affected by the statistical issue of ‘survivorship bias’ which affects many financial performance indicators. Put very simply, those firms which fail disappear from the data and can no longer drag down the average. The bias is even stronger if the successful firms are able to profit from the demise of weaker counterparts. By definition, the only participants who could have taken part in the most recent surveys were the ones which survived. This does not invalidate the findings, but it does suggest that the data should be treated with caution.

There is evidence from a number of other markets which have been deregulated and / or opened up to wider competition over the last 25 years that consolidation and market concentration are almost inevitable. This process of consolidation produces winners and losers. Big winners, of course, are more visible than smaller losers. It is therefore not surprising that larger firms tend to be the ones reporting growth, while many smaller firms are suffering in the heat of new competition. This can produce an unusual statistical pattern known as the ‘bimodal distribution’. Instead of looking like an upturned V, with a single peak in the middle, the graph looks like an upturned W with two clusters – lesser-performing firms on one side, successful ones on the other, and not much in between. This pattern was seen in the UK accountancy profession a decade ago, and may now have transferred to the legal sector.

Political influence has also been felt differently across the profession. The austerity agenda has affected a large number of smaller firms, while leaving many larger firms unscathed. Following the Jackson reforms, there has also been a concerted drive to reduce the costs associated with civil litigation, particularly in personal injury. This seems to have had only a limited impact on well-managed specialist personal injury firms, which invested in technology and processing systems to operate more efficiently, but it has had a significant effect on mixed practices with a small personal injury department, which have not had the critical mass to justify such investment.

So, although it may seem confusing that we can simultaneously have a growing market but also a number of threats hanging over many firms, there is a logic to it. The impact on your business will depend on decisions you took some time ago. If you addressed your management issues, kept (or rebuilt) a strong balance sheet and close client relationships, and positioned your firm away from sectors most susceptible to political influence, then you have good reason to feel optimistic. But, if you have not reorganised your operations to meet the new challenges of the market, and are faced with an unyielding monopoly buyer intent on extracting more for less, you will probably have to run ever faster simply to stand still.

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