Open *season*

Deregulation has changed the legal services market forever. ***Barry Wilkinson*** *looks at the lessons to be learnt from other deregulated markets, and how law firms can apply those lessons to make sure they succeed*

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In digest

- Firms must understand the open market dynamic in order to survive
- Low-cost providers will rapidly segment the market, which will come to resemble an hourglass after a four-phase process. The danger lies in the 'gastric band' in the middle
- The new market will still present opportunities for talented partners and firms with a strong strategy. Doing nothing is not an option

Until 2012, the legal market enjoyed an element of protection from the full forces of open markets, because of the regulations which prohibited non-lawyers from running legal businesses. Since the announcement of the deregulation of the market, enacted by the Legal Services Act 2007 and brought into force in 2012, there has been considerable speculation about the impact of deregulation on the legal market. In research we conducted in 2011 (Wilkinson Read & Partners, *White Paper 2011*: *Beyond ABS – The Future For Independent Law Firms*), a majority of respondents felt that the impact would be significant on the market as a whole, but bizarrely an even larger majority felt that there would be no impact on their own firm. Overall, the research identified that law firm partners found it difficult to predict the shape of the future market; external observers from banks, business schools and the finance profession are actually clearer about the overall shape of the new market, if not the detail, because deregulation means that the legal market will now behave like other open markets.

One thing which is clear is that market dislocation creates winners and losers. If firms understand the market dynamic which is being played out, and the attributes of winners, they will be able to select the appropriate strategies and actions to not only survive but thrive in the market of the future.

THE THEORY OF MARKET DYNAMICS

Professional service markets, like other services, have very low intrinsic barriers to entry. Over 25 years' worth of deregulation in such markets shows the same pattern: when regulatory barriers are dismantled, the market will eventually become like any other, but the process of removing those barriers creates a dislocation, enabling the release of previously pent-up forces. In the case of the legal market, the late onset of deregulation means that other forces such as globalisation and technology will amplify and accelerate the impacts of the change.

These factors in turn open the door to low-cost competition, which also changes the shape of markets, but again in a way which can often be predicted, given the experience of the last 15 years.

Professor Adrian Ryans posits, in his book *Beating Low Cost Competition: How Premium Brands Can Respond to Cut-Price Rivals* (John Wiley & Sons, 2009), that once low-cost competition invades the market, a four-phase process kicks in that results in a market structure he describes as an hourglass. This kind of market has strong premium brands at the top end, strong low-cost providers at the bottom, and a 'hollow middle'. Low-cost competitors rarely attempt to start by providing the same quality and specification of product and service as incumbent providers, but instead set out to redefine the specification, and provide products and services which are 'good enough' for the mass market. Typically, these competitors will offer price reductions of around 50-70 %. With this level of savings on offer, many customers understandably desert their existing provider, while many of the rest decide that, if they are going to be paying a premium (as they will now be), they would rather have something which is really worth it and move upmarket. A low-cost provider often ends up as the market leader and most profitable player, despite its low prices. Readers will recognise the example of the European aviation

industry, in which British Airways remains profitable at the top end, but the low-cost, 'no-frills' Ryanair is now the largest and most profitable carrier in Europe, despite having been just a minnow as recently as 1998.

Professor Ryans has also identified a number of strategies which can be employed by established businesses to combat low-cost competition. I explore both his theory in more detail, and his strategies, below.

THE LEGAL MARKET – BEFORE AND AFTER

The impacts of deregulation, globalisation, technology and low-cost competition on the legal market will follow a similar path to that detailed by Professor Ryans, but with specific variants, as described below.

Pre-2012

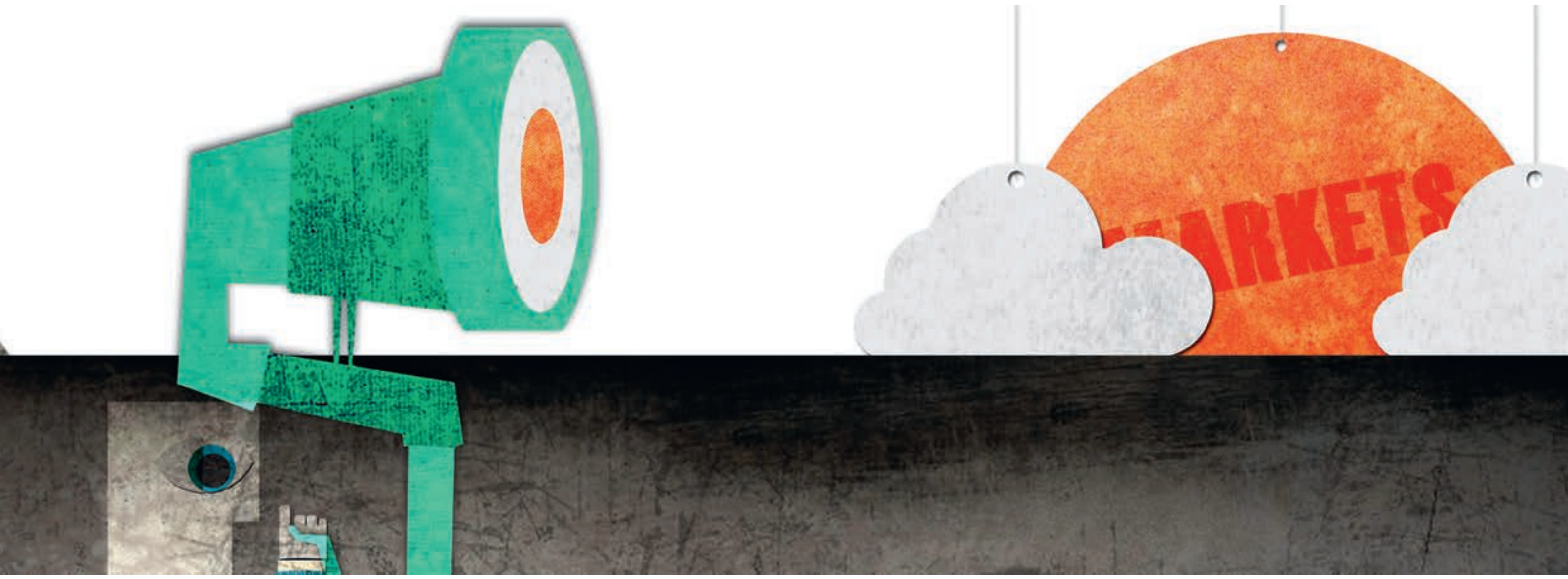
Before 2012, there was little room for anyone but lawyers in the market.

The top end of the market was chiefly dominated by large or specialist firms, mostly based in London or the major cities, and primarily dealing in commercial (business-to-business) law. These firms offered premium services, underpinned by globally-renowned expertise and worldwide confidence in the English legal system. The top firms had very strong brands, international connections, and highly developed technology platforms.

The next level down was the middle market of provincial and high street firms, mainly operating outside central London, servicing private clients and owner-managed businesses. By the standards of many other businesses, this sector was strong and highly profitable, and at the top end could even compete with the first group; however, many of these businesses were thinly capitalised, with limited (by current standards) technology and a reliance on traditional methods and standards of service. By number of firms, this was overwhelmingly the dominant sector of the market.

Below this sat the transaction / process firms – the small but significant number of 'legal factories' devoted to transaction processing, mainly business-to-consumer (B2C), in some cases offering an element of low-cost competition.

Finally, there was a very small section of the market providing 'pseudo-legal' services, such as will-writers, which generally represented little threat to the established profession.



Post-deregulation phase 1

During this phase, the top three levels of the market will remain much the same, while the market will grow from the 'bottom' – the non-lawyer-owned businesses and new market entrants.

As in any deregulated market, particularly one with historically high profit margins, new competitors will enter the market and create their business model from a blank sheet of paper, perhaps using external capital, certainly harnessing the most recent technology, and with a different perception and definition of service. Almost certainly, they will focus less on relationships and personal contact, and far more on technology and rapid response – which, in 2013, means web-based, 'always on' services. They will be keen to take the 'good enough' approach, and have carefully defined product specifications which allow the client to choose both how much they want, and how much they are prepared, to pay, with an inevitable assumption that there will be some element of 'do-it-yourself' which allows the client to do the simpler tasks without paying for them.

Some of these providers will lose their money – capitalism being, after all, about risk as well as reward. The failures will doubtless be loudly trumpeted. But others will find a successful market for their service and develop a client base and a degree of market traction. As a result, the overall size of the legal market will grow, albeit largely from the bottom, with most of the growth going to the new providers rather than to existing incumbents.

Further upmarket, those firms with good management, strong finances, advanced technology and global links will begin to make their legal processes less labour-intensive and drive down the cost of delivery, recognising that they will be expected to pass the savings on to clients in the form of more competitive prices.

Phase 2

This phase will see upward encroachment from those new market entrants which found a profitable market for their products. They will start to become more ambitious in extending their client base and their pricing and margin aspirations, and attack the existing market, primarily the traditional B2C and owner-managed business market of the high street and provincial firms, and at lower prices than existing firms can offer.

The inevitable response from existing firms will be to cut their prices in an attempt to hold on to the business.

Phase 3

During this phase, traditional providers will start to consolidate as a defence mechanism against the encroaching new entrants. This is the point at which the market will start to clearly identify the winners and losers.

Cutting prices without cutting costs is a recipe for disaster, so firms will seek to cut overheads. This will involve mergers and takeovers,

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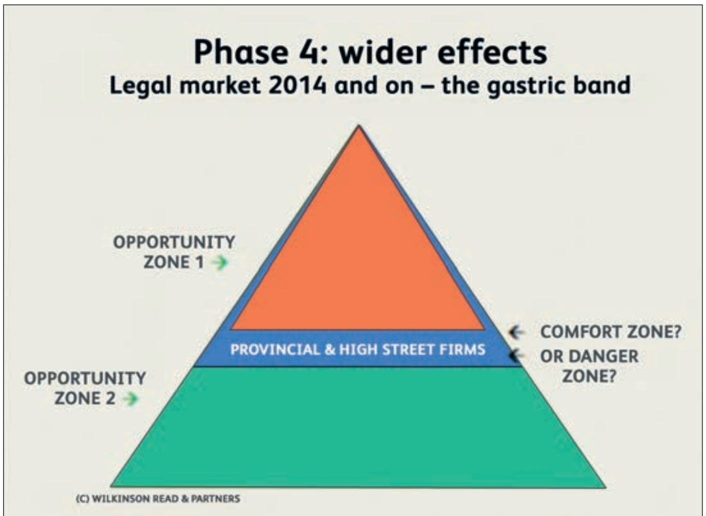
THE QUEEN'S AWARDS FOR ENTERPRISE: INTERNATIONAL TRADE 2012 but little attempt to change the basic business model. Some of this consolidation will be genuine mergers, but in most cases, a strong firm will be taking over a weaker one. This will be portrayed as dynamic growth, but in the bigger picture is actually defensive consolidation: protecting an ever-increasing share of a steadily shrinking territory.

Since consolidation will be inevitable, firms must ensure that, whether they are taking over other firms or looking for a 'friendly' merger, they are strong enough to merge on satisfactory terms.

Phase 4

We think that the legal market will have its own version of the 'hollow middle'. As with other markets, clients will decide that they will go one of two ways: either trade down to a much cheaper service which is good enough for their needs; or decide that, for a bit more, they can get a much better service, and trade up. But the pressures on firms in the middle may be slightly different to those in other markets. This is shown in the figure below.

There will be two main zones where there remains real opportunity in the market – the top and the bottom. Pressure from above will come because the biggest firms, through their use of technology, outsourcing and so on, will be able to deliver a better, quicker service, more cheaply than traditional providers, and so will invade the market of the next-level firms. This will cause a ripple effect from the top mid-level level firms downwards. Meanwhile, the advance of the low-cost providers – particularly those making the best use of technology and 'good enough' solutions – will put ever greater pressure on the traditional service model, thereby forcing down the price of current services to the point that they may become uneconomic.



The effect of all this will be huge shrinkage in the middle ground – we see this as being so severe that we are calling it the 'gastric band'. We believe that the top 2,000 firms will have a half-life: they will merge and become 1,000 within three to five years, and within another three to five years, they will become 500, and so on. Or to put it another way, your firm has a one in four chance of being around in its current form within six to 10 years. The middle will no longer be the comfort zone, but the danger zone.

We also foresee a number of other changes in the market during this phase.

Some of the partners and / or departments involved in mergers will not like the consolidation process and so will spin off and create their own firms – often niche with very low overheads, but upgraded technology and processes.

In other markets, the consolidation would also force out many smaller operators, but the Successor Practice Rules make that very difficult in the legal market. The result may well be many 'zombie firms' hanging on, barely making a living, but avoiding the need for run-off cover, until and unless insurers put them out of their misery by withdrawing cover.

OPPORTUNITY IN THE NEW MARKET

It would be easy at this point to allow the potential squeeze in this new market to obscure the opportunities which will arise.

To start with, the market will grow, so there will be winners as well as losers. Just because there are fewer firms, that does not mean that there will be less opportunity for talented partners who wish to continue to practise.

The right strategy for your firm will depend on many factors, including its market position, client base and pricing model, but some options are open to firms, including the following.

- Use a strong balance sheet to keep taking over firms, teams and lateral hires to get more output from the same infrastructure. This is not a permanent answer but should last 10-20 years, and so take many partners through to retirement.
- Get yourselves in shape to merge on acceptable terms with a business taking the above course of action.
- Focus on sectors of your market which continue to value quality, relationships and personal service, and provide them with the best quality and service, now and in the future, to attract and retain their business.
- Significantly upgrade service and value, to be seen as the up-market option in your market.
- Focus on specific profitable niches which are related to your current market and client base and which may well not offer sufficient scale to appeal to the big players.
- Upgrade your IT infrastructure and processes to steadily drive down costs while improving service. This will put you in a good position to defend your existing position against low-cost entrants, maintain your existing client base, and survive at the expense of less efficient local competitors.

These are just some potential strategies you could employ to take advantage of the opportunities in the market, but first you need to position yourself to be a winner. Just as in other markets, there is no one right answer or single route to ensuring that you are one of those winners – aviation has room for both British Airways and Ryanair, while the most successful retailers are currently Waitrose and Aldi, which could hardly be more different businesses. You have to choose the right strategy for your firm. However, all winners in deregulated markets will have clear and consistent strategies, covering: finance; client profiling and selection; product and service portfolio; people; and management and structure.

I will cover these issues in greater detail in a future article for *Managing for Success.*

FACING THE REALITY

Open markets are impersonal and unforgiving. Firms which have significant issues have only a limited time to get their house in order before the pressure of the 'gastric band' starts to tell. The one option which will not work is to do nothing and hope the problem goes away. Doing what you currently do, in the way that you currently do it, will hand the market over to competitors of one kind or another.

Deregulation means that the legal market will be changed forever, just as the government intended. It will create winners and losers. The primary task of partners is to ensure that your firm is among the winners. Understanding the market dynamic can help you to be significantly better placed than your competitors.