

Revenue Per Equity Partner

A Useful Metric of Law Firm Financial Performance

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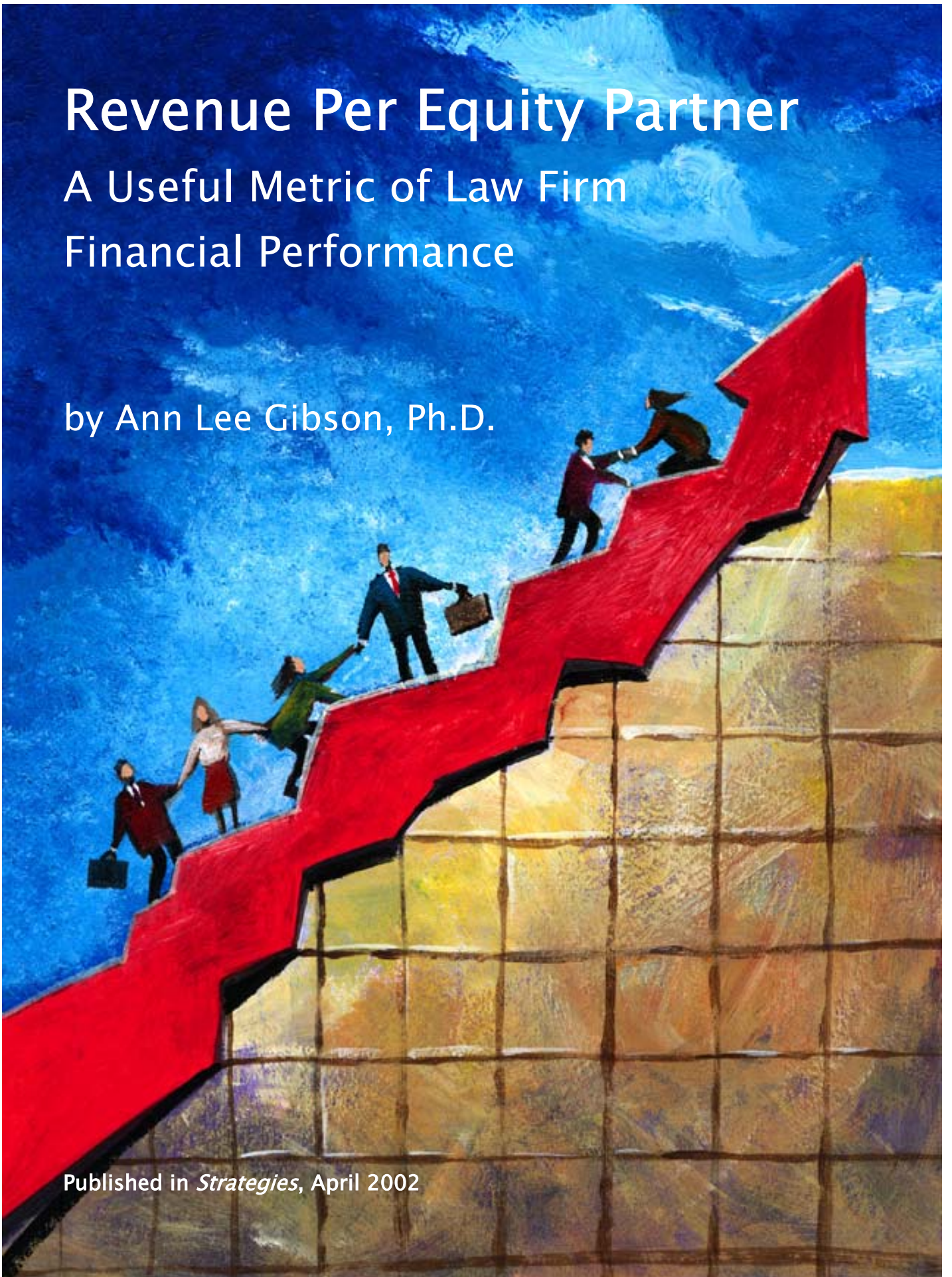


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Revenue Per Equity Partner— a Useful Metric of Law Firm Financial Performance

By Ann Lee Gibson, Ph.D.

Summary

The metric “revenue per equity partner” offers more useful and predictive information about a firm’s ability to produce revenue that actually winds up on the bottom line in partner *profits*.

A basic management precept says that because organizations get what they reward and reward what they measure, organizations therefore get what they measure. For this reason, the legal marketplace should be careful about how it measures and compares law firms—including the specific revenue metrics it uses to evaluate firms’ performances.

Most of us are accustomed to evaluating revenue metrics on the basis of “bigger is better.” For example, if Company A’s revenues are higher than Company B’s, we view Company A as having performed better than Company B. Likewise, if a company’s revenues in Year 2 are higher than in Year 1, we view that company as having performed better in Year 2.

This article posits that the two revenue metrics used most often to describe law firms’ financial performance—gross revenue and revenue per lawyer—are not the only and perhaps not even the best revenue metrics to describe law firms’ operational and financial performance.

I propose that an additional revenue metric—revenue per equity partner (RPEP)—offers more useful and predictive information about a firm’s ability to produce revenue that actually winds up on the bottom line in partner *profits*. This RPEP metric also has the advantage that the factors that define it are already reported in the legal marketplace.

Inadequacy of the “Gross Revenue” Metric

Gross revenue (*a la* “The Amlaw 100”) as a financial metric to distinguish among U.S. law firms has its obvious uses, but is insufficient by itself to describe the revenue performance of U.S. law firms. The reasons for this metric’s limitations lie in: a) several limitations placed on law firm growth and revenue by bar regulations, b) the tremendous importance of

Misuse of the “revenue per lawyer” metric in comparing law firms stems from the fact that leverage at law firms varies dramatically—during 2000, leverage ranged from 1.72 to 6.61 across Amlaw 100 and Amlaw 200 law firms.

individual relationships in the legal industry (influencing buying behavior perhaps more than in any other industry), and c) the extent to which law firms are choosing more than ever to grow through merger and acquisition.

More so than in other professional services industries, growth within U.S. law firms is regulated by bar associations. With few exceptions, U.S. law firms are permitted to provide only legal services and may not grow through diversification like most other businesses are allowed to grow. Growth among full-service law firms is also limited by strict conflict of interest rules, which prevent even several firms from becoming the dominant legal providers to large client industries.

In the U.S., client buying behaviors of legal services emphasize “people hiring people.” As a result, business law firms’ services are sold and purchased mainly as a function of personal and professional relationships. Firm growth is therefore limited by the capacity its lawyers have to develop and maintain close relationships with current and prospective business clients. This buying dynamic also prevents a “Big 5” corollary—that is, a small number of law firms becoming the dominant providers of legal services in the U.S.

Another factor that muddies the interpretation of “gross revenue” as a measure of financial performance is the considerable extent to which law firms are growing through mergers and acquisitions. Some firms have seen dramatic increases in revenues from one year to the next, not because they performed “better” in any financial sense, but because they acquired other firms.

Inadequacy of the “Revenue Per Lawyer” Metric

In law firm circles, the oft-cited and oft-misleading revenue per lawyer (RPL) metric is calculated by dividing a firm’s gross revenue by the number of lawyers at that firm. Misuse of the RPL metric in comparing law firms stems from the fact that leverage at law firms varies dramatically—during 2000, leverage ranged from 1.72 to 6.61 across Amlaw 100 and Amlaw 200 law firms. All else being equal, the more lower-billing associates a firm adds to its ranks, the more that firm will necessarily lower any calculation of its RPL. Therefore, using RPL as a basis to evaluate the performance

of different firms or the same firm over time can invite massive misinterpretation of those firms' financial performance.

Reinterpreting Maister's Model of Law Firm Profitability

In 1984, David Maister published in *American Lawyer* a model for law firm profitability. Since then, that publication has used this model as the basis for its annually reported financial performance reports about the "Amlaw 100 firms"—the 100 highest-grossing law firms.¹

Maister's formula describing law firm profitability is:

NIPP = (1 + L) x (BR) x (U) x (R) x (M), where,

NIPP = Net income per partner

L = Leverage (ratio of associates to partners)

BR = The blended hourly billing rate

U = Utilization (client hours recorded)

R = Realization (revenues divided by "standard value" of time recorded)

M = Margin (partners' profits divided by revenues)

A much simpler way to express NIPP—a term more commonly referred to as profits per equity partner or PPEP—is found below in Gibson's restatement of Maister's formula:

PPEP = (RPEP) x (M), where

RPEP = Revenue per equity partner (firm gross revenues divided by the number of equity partners)

M = Margin (partners' profits divided by revenues)

In this restatement of Maister's model, revenue per equity partner or RPEP equates to Maister's expression of $(1 + L) \times (BR) \times (U) \times (R)$. RPEP has the advantage of being captured and calculated much more easily than is Maister's expression. However, RPEP describes just as fully how leveraged a law firm is, how busy that firm is, how much that firm charges for its services, and how much of those fees that firm collects.

The greatest value of RPEP as a metric of law firm performance is that it collapses into a single variable all revenue-related performance information about a law firm, just as the Maister notation "M" collapses all cost-control performance about a law firm into a single variable.

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¹ In recent years, *American Lawyer* has also published financial performance data about the "Amlaw 200 firms"—the second 100 highest-grossing law firms.

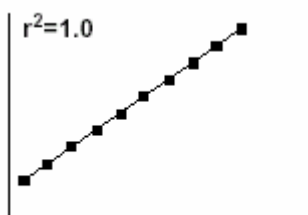
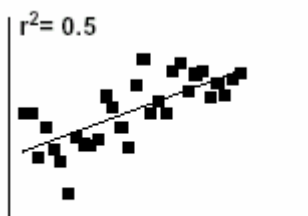
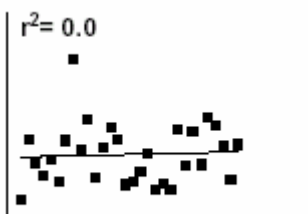
How to Interpret Squared Correlation Coefficients

For those not familiar with correlation coefficients and how to interpret them, the following brief discussion will be helpful.²

When two variables vary together, statisticians say that there is a lot of correlation. Statisticians measure the extent of correlation between two variables by calculating the linear correlation coefficient or “R.” The value of R quantifies the direction and magnitude of correlation. R can be any number between negative one and one and measures how close to a straight line a set of points falls. The closer to zero the correlation coefficient is, the less the points fall on a straight line—hence, the term “linear” correlation coefficient.

Perhaps the best way to interpret the value of R is to square it to calculate R^2 . This quantity is referred to as the *coefficient of determination* or *R squared*. It has a value that ranges from zero to one and is the fraction of the variance in the two variables that is shared. Like R, the value of R^2 is also a measure of how strong the relationship is between two variables. The higher the R^2 value, the stronger the relationship is between the two variables. For example, if $R^2 = 0.59$, then 59% of the variance in X can be explained by variation in Y. Likewise, 59% of the variance in Y can be explained by (or goes along with) variation in X. More simply, 59% of the variance is shared between X and Y.

In this paper, we are exploring the relationship between two financial indicators of U.S. law firms—PPEP and RPEP. As noted above, the highest an R^2 value can be is 1, a value that would describe a perfect relationship between two variables. Therefore, a positive and perfect, *albeit fictional*, correlation between PPEP and RPEP would be expressed by the correlation coefficient $R^2 = 1$. Under that scenario, the firm with the lowest PPEP would have the lowest RPEP, the firm with the second-lowest PPEP would have the second-lowest RPEP, the firm with the third-lowest PPEP would have the third-lowest RPEP—all the way up to the firm with the highest PPEP, which would have the highest RPEP. Another way to describe this kind of a perfect *but fictional* relationship



² Much of the discussion in this section, “How to Interpret Squared Correlation Coefficients” was extracted from the book, *Analyzing Data with GraphPad Prism*, available at <http://www.graphpad.com/articles/AnalyzingData.pdf>.

is that among U.S. law firms, 100% of the variance among those firms’ PPEP metrics could be explained (predicted) by the RPEP metrics at those firms (and vice versa).

By contrast, under a different scenario where $R^2 = 0$, there would be an unpredictable (random) relationship between PPEP and RPEP. A chart describing this non-relationship between the two variables would show data points located randomly across the chart and might also display a trend line that was horizontal.

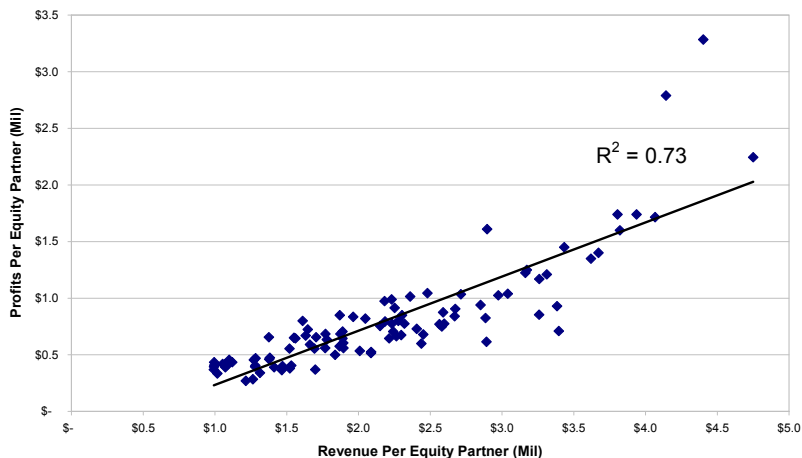
Predictiveness of the “Revenue Per Equity Lawyer” Metric

In 2000, 73% of the variance in profits per equity partner at Amlaw 100 firms could be explained (predicted) by the variance in revenue per equity partners at those firms.

In its annual Amlaw 100 and Amlaw 200 reports (in July and August of each year), *American Lawyer* does not report RPEP statistics for law firms, but it does supply all the information needed to calculate RPEP. As noted above, RPEP is easily calculated by dividing a firm’s gross revenues by the number of equity partners at that firm.

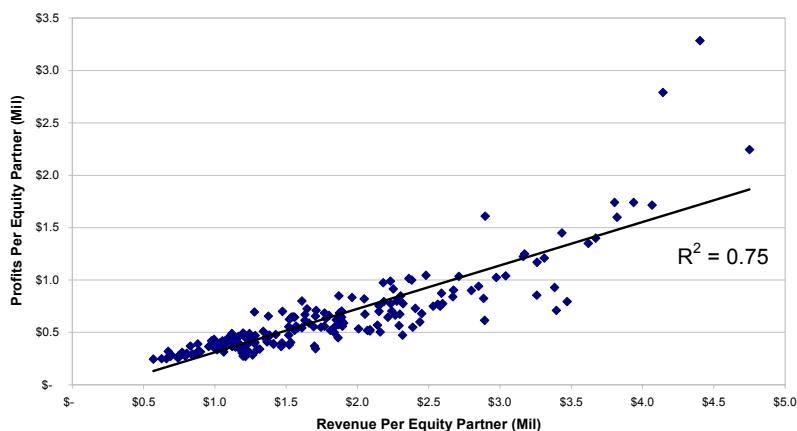
Because RPEP collapses so much information about a firm’s performance (its leverage, industriousness, billings, and collections) into a single statistic, RPEP does correlate highly and positively with PPEP. The correlation between PPEP and RPEP during 2000 for Amlaw 100 firms ($R^2 = 0.73$) can be seen in Table 1 below. This means that 73% of the variance in PPEP at those firms can be explained (predicted) by the variation in RPEP at those firms.

Table 1: Correlation Between Profits Per Equity Partner and Revenue Per Equity Partner, Amlaw 100 Firms, CY 2000



The relationship between PPEP and RPEP during 2000 for both Amlaw 100 and Amlaw 200 firms during 2000 ($R^2 = 0.75$) can be seen in Table 2 below. This means that 75% of the variance in PPEP at those firms can be explained (predicted) by the variation in RPEP at those firms.

Table 2: Correlation Between Profits Per Equity Partner and Revenue Per Equity Partner, Amlaw 100 and 200 Firms, CY 2000



Outlier firms that lie considerably above the trend line appear to employ a different business model than other firms, e.g., they do not limit fee arrangements to actual time attorneys work on client matters.

The R^2 values reported in Tables 1 and 2 above are nearly the same ($R^2 = 0.73$ and $R^2 = 0.75$). Therefore, the relationship between PPEP and RPEP appears to hold true in 2000 at both Amlaw 100 firms, where revenues ranged from \$145 million to \$1.154 billion, and Amlaw 200 firms, where revenues ranged from \$67 million to \$145 million. Unanswered by these data is the question of how consistently this relationship between PPEP and RPEP applies to firms smaller than the Amlaw 200 firms—those with gross revenues lower than \$67 million.

An especially interesting aspect of these PPEP / RPEP correlation charts is the appearance of outlier³ firms that lie considerably above the trend line. These firms (Wachtell Lipton, Robins Kaplan, Cahill Gordon, etc.) appear to employ a different business model than do other firms. An obvious interpretation is that these outlier firms do not limit their fee arrangements only to the actual time that firm attorneys work on client matters.

³ D.M. Hawkins defines “outlier” as: an observation that deviates so much from other observations as to arouse suspicions that it was generated by a different mechanism. Hawkins, D.M. (1980) *Identification of Outliers*. Chapman and Hall, London.

Revenue per equity partner is an even better predictor of profits per equity partner than Amlaw's "Profitability Index."

It is also interesting that the degree of correlation between PPEP and RPEP for both Amlaw 100 and Amlaw 200 firms during 2000 ($R^2 = 0.75$) was higher than that between PPEP and any other publicly reported measure of law firm operational or financial performance, including: the number of lawyers at a firm (a factor commonly but mistakenly believed to correlate highly with firm profitability) ($R^2 = .03$); leverage ($R^2 = 0.12$); profit margin ($R^2 = 0.27$); and even Amlaw's "profitability index"⁴ ($R^2 = 0.65$). This last R^2 value means that Amlaw's profitability index (PI) is not as predictive of law firms' successes in converting revenue into profits as is the RPEP metric, as measured by the correlations between each of these two metrics and reported PPEP ($R^2 = 0.75$ for PPEP / RPEP and $R^2 = 0.65$ for PPEP / PI).

PPEP / RPEP Correlations May Predict Law Firm Economic Cycles

The R^2 values describing the relationship between PPEP and RPEP for Amlaw 100 firms during the five years preceding 2000 (1995, 1996, 1997, 1998 and 1999) were also extremely high: $R^2 = 0.72, 0.80, 0.80, 0.82,$ and 0.77 , respectively. Therefore, the utility of RPEP to predict PPEP is shown to hold up over time.

Interestingly, the swing from lower to higher to lower again for PPEP / RPEP squared correlation coefficients among Amlaw 100 firms during the six years 1995 through 2000 ($R^2 = 0.72, 0.80, 0.80, 0.82, 0.77,$ and 0.73 , respectively) begs the questions: Do higher degrees of correlation between RPEP and PPEP for groups of law firms define economic good times, and do lower degrees of correlation define (or presage) not-so-good times? If so, this interpretation would align with common-sense observations of productivity within law firms and the (almost silly it is so obvious) basic principle of law firm profitability that law firms are more profitable when the lawyers at those firm are billing more.

⁴ "Profitability index" is defined by *American Lawyer* as "the ratio of profits per partner to revenue per lawyer. It measures a firm's success in converting revenue into profit and allows comparisons between firms with different leverage ratios."

The degree of correlation between RPEP and PPEP may prove to be a reliable economic indicator for the legal marketplace.

Conclusion

The proposition that RPEP is a metric more appropriate than gross revenues and revenue per lawyer for evaluating law firms' financial performance will not be a new concept to sophisticated chief financial officers and managing partners of U.S. law firms. However, RPEP as a financial metric is seldom mentioned in law firm management literature and, likewise, has received little attention among legal marketing circles as a metric of law firm financial performance.

The utility of the RPEP metric to predict partner profits and its potential utility to describe economic cycles (as demonstrated by the high but varying R^2 values resulting from RPEP and PPEP metrics achieved during 1995 through 2000 at Amlaw 100 firms) makes it worthy of even further consideration.

Marketing professionals and others working within law firms may use this RPEP metric to evaluate their own firms against competitor firms. Observers of the legal marketplace may use this RPEP metric to study and evaluate the structural and financial performance of individual law firms and industry segments. RPEP may also prove to be a useful metric by which to spot industry-wide changes.

I invite other researchers to inspect carefully the analyses described above and to offer their own observations about these relationships. My hope is that others who care about such matters will explore these issues further and provide additional insights through continued discussion and debate in publications, conferences, and online discussion groups that serve the legal marketplace.



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