Strategies | 1.09 V11.N01
The Journal of Legal Marketing
PUBLISHED BY LEGALMARKETINGASSOCIATION LMA

Client Size and Profitability– Do They Go Hand in Hand?

by Kris Satkunas

Concentrate on your key clients–a familiar mantra to many a law firm manager looking to boost the bottom line. But which clients should a firm designate as key? Where do you draw the line?

Firms derive the vast majority of their work from their largest clients. But an ironic–and sometimes overlooked–reality is that if a firm aims its focus too narrowly at only the very largest of its clients, it may miss opportunities to target clients that actually tend to be the firm's most profitable, if not the biggest.

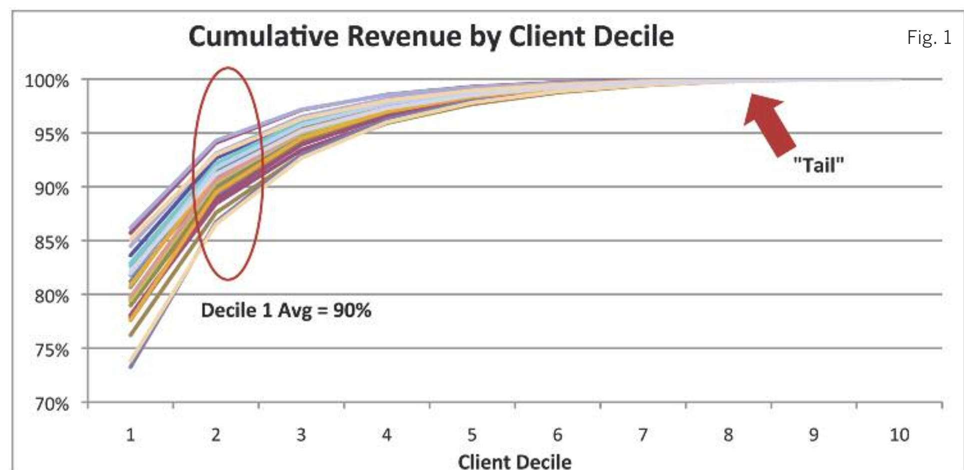
This premise may sound contrary to the conventional wisdom. The answer to this conundrum lies in a careful analysis of client profitability by client size–in other words, the amount of work a client delivers to the firm. A recent study Redwood Think Tank undertook underscores the analytic value of tracking profitability by ranking clients according to size. We looked at 25 law firms, using data concerning client size and profitability.

We know from prior studies that at most law firms, 90 percent of firm revenue comes from the top 20 percent of firm clients. While most call this the 80/20 rule, we previously have discovered that at large firms, i.e., those with several thousand clients or more, closer to 90 percent of their revenue comes from 20 percent of their clients. (See Fig. 1: Cumulative Revenue by Client Decile.) But given that at most large firms, 90 percent of their work comes from 20 percent of their clients, does 90 percent of their profit come from that same 20 percent of their client base? In other words, by focusing solely on client size, can a firm proportionately increase its bottom line?

Concentration at the Top

To gain a better understanding of just how much work was concentrated among the top clients of the firms in our study, we turned to a tool we often employ: client decile rankings. We break a firm's client base into ten deciles, so that Decile 1 contains the top 10 percent of the firm's largest clients, Decile 2 the next 10 percent, etc.

This simple approach is a powerful way to hone in on a firm's most crucial relationships. Decile 1 alone accounts for the vast majority of a firm's billable hours–nearly 80 percent. By contrast, the clients in Decile 10 typically bring in less than an hour of work a year. We further broke down the clients within Decile 1, i.e., the clients that account for the vast majority of billable work. For the 25 Redwood benchmarking firms, we learned that the top percentile–the top 1 percent of clients–were responsible for 37.6 percent of firms' work. Further, the top 2 percent of clients were responsible for 50.2 percent of firms' work.



Source: Redwood Think Tank

In line with previous Redwood studies, the firms were

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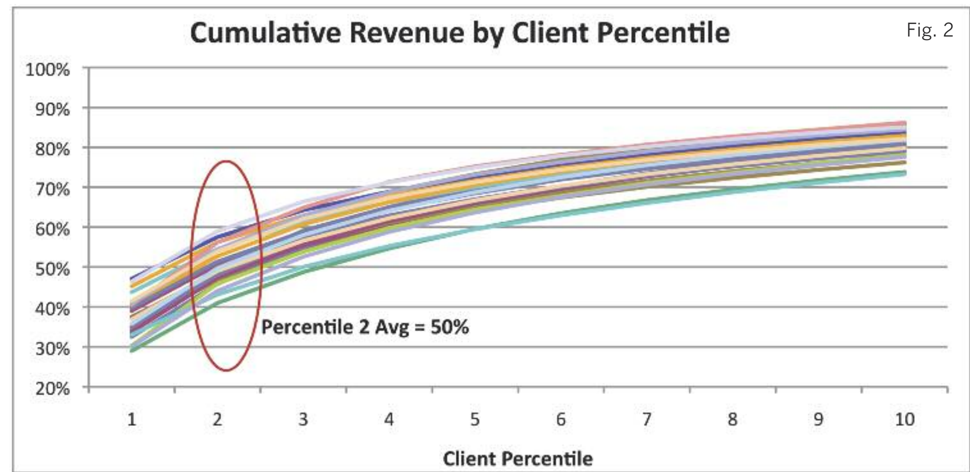
remarkably consistent; 18 of the 25 firms fell within 1 standard deviation of the 50.2 percent average—at the vast majority of those firms, half of their work came from just 2 percent of their clients. Hence, these numbers appear to be a solid benchmark for firms to use to assess their own client portfolios. (It should be noted that if a firm has one client that provides a substantial percentage of the firm's work, including this client in the mix may skew results. So firms should strip out clients such as these when analyzing trends among their client basis.)



Source: Redwood Think Tank

Profit Margins

Next, we looked to see whether client profit margins followed the same patterns. For the purposes of the study, we examined firms' direct or contribution margin—the profit after accounting for discounts, other losses and the hourly cost of those who performed the work. We did not account for overhead because overhead allocations to clients generally are not precise.

We found that while the top 1 percent of clients accounted for 37.6 percent of the work, they accounted for 36.5 percent of the direct margin. The profits from this group closely tracked the amount of work they provided—but weren't an exact match. These results aren't altogether surprising; the very largest clients tend to obtain the largest discounts, so while they send firms the most work, their direct margins may be lower.

Firms make up for some of this lower-margin work from their largest clients by effectively leveraging their staffing on matters for such clients. However, firms also make up for lower direct margins from such clients by obtaining better margins from clients within the next few percentiles.

Here's the money quote: While a firm's Decile 1 clients generally are the firm's largest, most profitable clients, the clients that are the most profitable within that group may well be those that are in the second and third percentiles.

Why does this matter? Think of a firm's typical business development efforts. If a firm has 5,000 clients, there are 500 clients in the first decile, and 50 in the first percentile. A firm that is only focusing its business-development efforts on its top 50 clients is wining and dining the very clients that receive the largest discounts—and may be underdeveloping clients that pay the highest margins for its services.

By broadening business-development efforts to focus on the next couple of hundred clients, a firm can reach out to those that are slightly more profitable.

Keep in mind, however, that regardless of where a firm chooses to draw the line at development of its large clients, the Decile 1 clients as a whole are its most important in terms of work brought in and profits. It would be a red herring to separate client size from profitability.

Which brings us to our final point. Firms that do not manage their "tail" clients—those that bring in hardly any work at all—fail to do so at their peril. We looked at the clients in Decile 10 of the 25 firms we studied. On average, the annual standard production value brought in by a Decile 10 client was $162—less than one hour of work. And fully 10 percent of firms' clients were bringing in that meager amount.

This tells us that not many firms have intake procedures that keep their attorneys from accepting matters that administratively are not worth the time. And the argument that tiny clients, i.e., "acorns" may grow to become larger clients, the "mighty oaks" of the future, doesn't hold weight. Analyses done by the Redwood Think Tank indicate that "acorn" clients almost never grow to become "oaks." (See September 2007, "Cracking the Acorn Theory," p. 4.)

The results are clear. Client size and profitability are closely linked. Therefore, firms that focus on growing their large clients—albeit those that are in the top several percentiles as opposed to only the top 1 percent—are likely to improve their bottom line.

On the other end of the spectrum, firms should also attempt to better manage their intake process to avoid accepting matters from clients seeking to bring the firm very small amounts of work. Attention to the tail-end of the client base will help boost profitability, too. ■

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