

EXTRACTING VALUE FROM CLIENT RELATIONSHIPS: EXPERTISE AND CROSS-SELLING IN THE UK LEGAL MARKET

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INTRODUCTION

How value is shared in a vertical chain has been an important concern for strategy research and practice at least since Porter (1980) stressed the importance of buyer and supplier power for determining an industry's capability. I empirically examine two drivers of suppliers' value capture. The first is the distinctiveness of suppliers' expertise compared to what their clients can get from competitors. The second is the realization of client-based scope economies through cross-selling, both by a focal supplier but also by its competitors. I investigate the impact of these drivers on supplier profitability and buyer-supplier relationships stability by analyzing a unique longitudinal data set from the UK corporate legal market. This data set comprises the client relationships of the largest UK law firms with FTSE 250 corporations, experts' assessment of the capabilities of law firms in different legal areas, and law firms' characteristics, including their profitability. I base my theorizing and my measurements on the value-based framework proposed by Brandenburger and Stuart (1996). This framework is particularly appropriate for modeling competition between a small number of heterogeneous firms within a vertical chain, and understanding the drivers of value creation and value capture. The contribution of this paper is two-fold. Substantively, my study is one of the first to analyze the performance impact of competition among suppliers by taking into account the role of differences in expertise among suppliers and the role of cross-selling. Methodologically, this paper is the first empirical study that explicitly bases its approach on the value-based framework of Brandenburger and Stuart (1996).

BACKGROUND AND THEORETICAL FRAMEWORK

Value Creation through Expertise and Client-Based Scope Economies

Professional firms represent a substantial size of the economy and are quintessential examples of knowledge-based organization (The Economist, 2006). Law firms are one type of professional firms along with accounting firms, consulting firms and architecture firms for instance. These firms use the knowledge of their employees and partners to deliver specialized services to their clients (Maister, 1993). In addition to creating value with their expertise in different legal areas, law firms also create value by providing a "one-stop-shopping" to their client. There are two elements how "one-stop-shopping" may create additional value. The first is the creation of customer-specific knowledge. The second element is the coordination of various services for the client: the work of specialist lawyers in different fields may need to be coordinated as some clients need simultaneous advice in different areas of law. When a law firm manages several related issues for a client, better coordination may result in costs saving, increased quality of work, or both. In each of those cases more value is created. The practice of

selling different services to a same client is called “cross-selling” in the legal industry and is very common among law firms.

In this paper, I broadly call “client-based scope economies” the cost savings and additional benefits that can be realized when a single firm provides advice to the same client in different legal areas. Client-based economies of scope differ from the usual concept of economies of scope (Panzar & Willig, 1981) in that they arise only when different products are made for the same client whereas production economies of scope arise when two different goods are produced by the same firm, regardless of the identity of the buyer. Client-based scope economies are akin to the demand-side economies of scope analyzed by Siggelkow in his study of mutual fund performance (2003). The definition I use in this paper is broader because, to explain the existence of scope economies, it also allows for the possibility of additional benefits to the relationship in addition to the sharing of shopping costs (Klemperer, 1992), i.e. the costs of using more than one supplier.

Value-Based Framework

The value-based framework developed by Brandenburger and Stuart (1996) provides a natural way for linking value creation and value appropriation when a small number of heterogeneous firms are competing in a vertical chain. I develop this theme in the rest of this section.

Brandenburger and Stuart (1996) base their reasoning on cooperative game theory (Owen, 1995) in order to understand how the value created by buyers and suppliers is shared among them. Their two central concepts are *value creation*, which represents the size of the pie to be shared, and *added value*, which gives indication as to how the pie will be shared. They define the value created by a firm as the difference between the willingness-to-pay of buyers and the opportunity cost of suppliers. They define the added value of a firm within a vertical chain as the amount of value creation that would be lost if the firm were to withdraw from the vertical chain. The construct of added value measures the distinctive contribution to value creation that a firm brings to a particular vertical chain. Such description applies well to business-to-business markets. I consider that markets for legal advice fit reasonably to this description to the extent that fees are typically at least partly negotiated. Moreover, negotiated fees and prices is a feature common to many business-to-business markets.

I apply this logic to the particular piece of the vertical chain that is constituted by one corporate buyer and the set of its suppliers of legal advice. I concentrate on this unit of analysis because the particulars of the legal market make it a relevant area of competition. The justification for this choice rests in the observation that bargaining situations in professional service markets rarely seems to include more than one buyer. Trade journals routinely report that buyers of legal service want to increase competition among their law firms, sometime to the effect of setting up reverse auctions.

Finally, I will make an important simplifying assumption in the forthcoming analysis. I will assume that the opportunity cost of the suppliers is constant, and focus on the variations of added value that come from variations in the willingness-to-pay they are able to command. This assumption is justified when one considers that the main driver of opportunity costs is the costs of the inputs necessary to produce the services. In the case of professional firms, input costs consist mainly of salaried lawyers’ and support staff salaries, which can be considered fixed in the short term.

Empirical Hypotheses for Law Firm Profitability

I will say that a law firm working for a client in a legal area has *added value* for this client in a given area if its level of expertise in the legal area is strictly superior to the comparable level of expertise of any of the other law firms working for the client. A law firm's aggregated value capture in each client relationship translates into its overall profits and should be related to its aggregated level of added value.

Hypothesis 1 (Expertise Advantage): The profitability of a law firm increases with the proportion of its clients for which it has added value in terms of pure legal expertise vis-à-vis the other law firms working for the same clients.

The other driver of value creation in client-law firm relationship is client-based economies of scope. If client-based economies of scope are realized by a law firm, this firm is in turn more likely to have added value. Indeed, by taking a coordinating role or by leveraging its knowledge of the client across different areas of law, it will be differentiating from its competitors. A necessary condition for the realization of economies of scope is that a firm is indeed selling its services to the same client in multiple areas, i.e., a firm is effectively cross-selling. Thus, I hypothesize:

Hypothesis 2 (Cross-Selling): The profitability of a law firm increases with the proportion of its clients for which it cross-sells.

Consider now the impact on a firm's added value with a client when there is a competitor that is realizing client-based economies of scope. This would likely reduce whatever added value the focal firm has in terms of pure legal expertise because now the competing firm would be able to compensate a possible expertise disadvantage due to its ability to bundle work in an area with work in other areas. Moreover, if the focal firm is also cross-selling, its added value from client-based scope economies would also be seriously reduced since it would no longer be the only supplier that realizes those economies. I therefore hypothesize:

Hypothesis 3 (Competitor Cross-Selling): The profitability of a law firm decreases with the proportion of its clients for which there is at least one competitor that cross-sells.

Empirical Hypotheses for Likelihood of Relationship Termination

The above hypotheses (H1 to H3) are formulated with a metric of value capture, law firm profitability, which is an aggregate measure of the profitability of multiple client relationships. Rather than using aggregate measures, one would ideally like to measure the profitability of each law firm's client relationship and relate it to the characteristics of the relationship. Instead of focusing on profitability at the law firm level, it is possible to observe and analyze an alternative measure of performance: the lack of termination (i.e., the survival) of the relationship over time.

I posit that client-law firm relationships in which either party is not able to capture enough value relative to alternatives are more likely to be terminated. A law firm may want to terminate a client relationship from which it cannot capture enough value. Conversely, a client may terminate a relationship with a law firm that is not willing to accept terms of exchange favorable enough to the client. Hypotheses 1 to 3 I formulated above can be translated in terms of relationship termination in the in the following way.

One can link the count of the number of areas of law in which the law firm has added value, i.e., areas in which the law firm has higher expertise than competitors, to the risk of seeing the relationship terminated and formulate the following hypothesis:

Hypothesis 4 (Expertise Advantage): The larger the number of areas a law firm sells to the client in which the law firm has added value vis-à-vis the other law firms working for the same client, the less likely the relationship is to be terminated.

To capture the role of cross-selling, the count of the total number of areas of law, including those with and those without an expertise advantage, can be introduced into the analysis. The more areas a firm is selling, the higher the benefits from coordinating among them and the less likely the relationship should be to be terminated. Accordingly:

Hypothesis 5 (Cross-Selling): The larger the number of areas a law firm sells to the client, the less likely the relationship is to be terminated.

When competitors cross-sell, the focal firm should be more at risk lose a client relationship due to the additional competitive pressure. If there is more than one competitor, added value theory suggests that one should take into account the most potent threat to the focal firm, which is represented by the competitor that is selling to the client the largest number of areas of law. Therefore:

Hypothesis 6 (Competitor Cross-Selling): The larger the maximum number of areas sold by a single competitor to the client, the more likely the relationship is to be terminated.

METHODS

The sample for this study was drawn from the UK legal market, between 2001 and 2005. The span of the study is 2001-2005. It comprises the largest 100 UK law firms and the largest foreign law firms in the UK between 2001 and 2005 (from *Legal Business* and *The Lawyer*) and the list of the law firms used by the top 250 largest market capitalization in the London stock market as given in a survey of their General Counsels (*Client Report*). In order to assess annually the level of expertise of law firms in all legal areas, I used the ratings provided by *Chambers and Partners* in their annual *Guide to the legal profession*. The Chambers directory covers over 60 areas of law, divided into further sub-categories, and provides ordered lists of the best firms and lawyers in the UK. For the analysis of law firm profitability, I have 453 firm-year observations from 128 firms. I use firm and year fixed effects in a linear regression with robust standard errors. For the analysis of relationship terminations, I constructed 1,872 yearly spells with 220 termination events. I used a logit model to estimate the likelihood of relationship termination.

Dependent and Independent Variables

Value capture. In the analysis of law firm profitability, I use the profit per equity partner (PEP) as dependent variable and measure of the extent of value capture by law firms. In the analysis of relationship termination, the dependent variable is the occurrence of a termination of relationship, coded as one, while the continuation is coded as zero.

Added value from legal expertise. I base this measure on information on law firm-client relationships given in the *Client Report* survey and on the firm ratings provided by the *Chambers* directory. I constructed the measure by following the following steps. I first looked at the sets of law firms mentioned by each client in the *Client Report* survey in each year. Within those sets of law firms, I matched the legal areas for which the client used a firm with the corresponding legal

area of *Chambers*. I then checked whether each firm had a strictly higher ranking in the relevant area of law of the *Chambers* directory than all the other firms working for the same client. If it was the case, I considered that the firm had added value for the work it was doing for this client in this area of law. I then computed the proportion of added value work out of the total client work. For the analysis of relationship termination, I constructed a count of the number of areas in which the law firm had added value.

Cross-selling. For each law firm, I calculated the proportion of its clients for which it was mentioned to work in more than one area of law. For the analysis of relationship termination I also constructed a count of the number of areas of law the client was currently purchasing from the firm.

Cross-selling by competitors. For each law firm, I calculated the proportion of its clients for which there was at least one competitor mentioned as working for the client in more than one area of law. For the analysis of relationship termination I constructed a variable equal to the maximum number of areas of law a single competitor of the firm is selling to the client.

Control Variables. I used the following control variables in the analysis: Level of legal expertise of the firm in the main areas of law; Leverage ratio (i.e.: the number of associates per partner); Headcount; Scope (measured as the number of areas in which the firm is active, in London and in the rest of the UK); Number of clients; Change in client's general counsel.

RESULTS

I first analyzed the profitability of law firms. The results lend support to Hypotheses 2 and, to a lesser extent, to Hypothesis 1 and 3. The signs of all variables are those that were hypothesized. The expertise added value variable (H1) is significant at a level close to the 5% threshold ($p = .058$) and the cross-selling variable (H2) is significant and below the 1% threshold ($p = .016$). The significance of the variable concerning cross-selling by competitors (H3) is below the 10% level ($p = .088$).

I found consistent and more statistically significant results for the analysis of relationship termination. There is a negative relationship and significant association ($p = .001$) between the probability of relationship termination and the expertise advantage of the firm (H4). The extent of cross-selling by the law firm (H5) also reduces the probability of losing the client ($p = .001$). Finally, more cross-selling by competitors (H6) is increasing the likelihood of tie termination ($p = .035$). Sharper results from this analysis may be attributed to the larger sample and less measured errors due to the use of disaggregated data.

Further investigation of the marginal effects showed that the effects of the theoretical variables are of tangible economic magnitude in both analyses.

DISCUSSION AND CONCLUSION

These empirical results have implications for understanding how competition unfolds in a vertical chain and the impact of client-based economies of scope. They also validate the relevance of the value-based framework for strategy research, and complement existing work on competition among professional service firms.

I found that the variables measuring competition at the level of client relationship significantly affected supplier profitability. This suggests that studying the structure of competition at a level as detailed as a buyer and its set of suppliers can be fruitful to understand

how the value created by exchange is shared between buyers and suppliers. This also suggests that a supplier's ability to capture value from relationships depends not only on its own characteristics (e.g., level of expertise) but also on how its clients actually enact competition. The idea that clients play a central role for the enactment of competition among their supplier base can be linked back to Baker's (1990) study of client relationships in investment banking. Buyers can gain power in the value chain by organizing how suppliers compete among each other (i.e., reducing suppliers' added value), while suppliers gain back power by increasing the distinctiveness of their contribution to value creation (i.e., increasing their added value), either by strengthening their capabilities or by choosing to serve clients that use weaker supplier.

Going beyond the analysis of the broader structure of the market to the analysis of each firm's particular set of constraints and opportunities seems a promising avenue of research for understanding how supplier and buyer power impact firms' performance and development. For instance, an interesting question is whether buyers' efforts to organize their supply chain are giving correct incentives to suppliers. There is indeed the possibility that excessively powerful buyers may be stifling suppliers' incentives to compete if suppliers are not able to capture enough of the value they create (Chatain & Zemsky, 2007).

Second, the results extend to our understanding of client-based scope economies. I find evidence that scope does not seem to provide benefits outside of the realization of client-based economies. These results mirror Siggelkow's (2003) findings that client-based economies of scope may be a driver of firm scope, even when there are no production-side scope economies. Moreover, I find that capturing benefits from client-based economies of scope is contingent on the competitive context in which they are realized. Clients using several suppliers simultaneously realizing such economies seem to be able to extract from the suppliers additional value created.

Third, this paper contributes to an empirical validation of the value-based framework (Brandenburger and Stuart, 1996). My results confirm that the terms of exchange between buyers and suppliers are influenced by the elements suggested by the value-based framework. In particular they provide evidence that the concept of added value can be fruitfully used to construct theoretically meaningful measures of competition. This also suggests a high potential of cross-fertilization between formal works (e.g., Makadok, 2001; Lippman & Rumelt, 2003; MacDonald & Ryall, 2003; Adner & Zemsky, 2005) and empirical analyses in strategy research.

This study has a number of limitations. The sample is drawn from the UK corporate legal market and there is the issue of generalization of results beyond that specific industry and country. Nevertheless, the question of how value is shared between buyers and suppliers is a feature common to virtually all business-to-business markets and is not specific to law firms. Similarly, although client-based economies of scope are especially salient in professional service markets, they also feature in manufacturing business-to-business markets. Moreover, there are a number of assumptions that were made that could be relaxed or whose boundary conditions could be more explicitly investigated. In particular, the assumption that competition is primarily among firms with existing tie needs to be relaxed to take into account entry of new firms in the set of supplier of a particular client. This question is also connected to the process by which buyer and supplier are matched. Anand and Galetovic (2006) suggest that high value client connect with highly skilled suppliers of services to create strong relationships while letting lower value clients and suppliers taking part to a transactional market. Explicitly accounting for the endogeneity of this process would strengthen the findings.

REFERENCES AVAILABLE FROM THE AUTHOR

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