WESTPAC INDUSTRY INSIGHT

Professional services.

May 2022

Contents

Paul Clark, Industry Economist
+64 9 336 5656
paul.clark@westpac.co.nz

Summary.

This report focuses on New Zealand's professional services sector. Firms operating in this sector provide an ever expanding range of knowledge-based services, from accounting, legal and architectural to management and engineering consulting. These firms provide services to all sectors of the economy, from individuals to large corporates and the government.

The professional services sector generates annual revenues of about $26bn.[1] There are about 43,000 firms in this sector, of which about 50% are sole owners, while another 40% or so are small operators, typically owned and managed by one or two partners. These small firms tend to specialise in a narrow range of practice areas. The sector also hosts a small number of very large multinational firms that deliver a wide range of services across different market segments and practice areas.

Demand for professional services reflects many factors. Some are structural in nature, such as changing sectoral contributions to the New Zealand economy and population demographics, and shape demand over time. Others are more cyclical, such as changes in economic activity, and have short-run impacts on demand.

Other demand factors have grown in importance over recent years. The most prominent of these is the rapid advance of new digital technologies, which are disrupting how downstream customers compete. That in turn is resulting in an increase in demand for some professional services and a drop off for others. At the same time, these digital technologies are providing customers with much easier access to information, which is helping to boost service expectations, as well as spur on competition among professional service providers.

Another is the growing awareness of environmental, social and governance issues. Increasingly, customers of the sector are looking for help to not only ensure that their views on issues such as climate change, environmental sustainability, transparency, inclusivity and equality closely align with those of their clients, suppliers, and even employees, but that they are taking practical steps to address these.

In response, professional services firms are using digital technologies to streamline their existing operating processes and automate time-consuming tasks. Not only does that take cost out of the system, but it also enables a shift up the value curve, as an increasing number of services become commoditised, and more professionals are redirected towards higher value work.

Other service providers are using digital technologies to increase their responsiveness to customer demands. Indeed, technologies such as cloud computing, blockchain, artificial intelligence (including chatbots), and knowledge management are increasingly being applied to all aspects of service delivery, from marketing and real-time bid management all the way through to procurement, project management and service implementation.

Others still are using digital technologies to transform their business models. Service providers are increasingly looking to become more customer centric, where the focus is on achieving outcomes that are best for the customer rather than service/delivery excellence. To achieve this, they are using digital technologies to implement flexible network models where scalable, multi-disciplinary teams take on end-to-end accountability for service delivery. They are also using digital technologies to access skills and talent, which is the lifeblood of the sector. This knowledge-based sector has traditionally traded on the skills, competencies, and knowledge of its people.

However, accessing talent has become increasingly difficult in recent years. Among other things that's because the sector, which has always looked to hire the "best and brightest", is facing increased competition from other sectors for the same skillsets. The blurring of the lines of distinction between different market segments within the sector will not have helped matters in this regard.

Required skillsets are also changing. As professional services firms have become more customer-centric, they are not only seeking out people with strong technical competencies, which will always remain important, but increasingly those with softer skills. EQ is becoming just as important as IQ, and the ability to collaborate and show empathy are becoming increasingly valued.

To address these challenges, professional services firms are tapping into talent marketplaces. There is nothing new in that – internal talent marketplaces have been around for a long time. What is new is the growth in external marketplaces that allow service providers to use the internet to access self-employed contractors or gig workers within and across national boundaries. That in turn is enabling firms to create virtual teams that can be tailored around specific tasks.

In this environment, we think there are three key things that professional services firms must get right.

Firstly, they must be clear about their market positioning. They need to know who their customers are, what their selling proposition is, and be able to align their operational capabilities to deliver on that. To achieve this, firms will need to adopt and implement digital technologies that allow a clear line of sight between customers and operational capabilities.

Secondly, they need to put the customer at the heart of their business. Increasingly customer success is becoming the new measure which professional services firms are using to assess their own performance. To achieve this, firms will have to continually innovate, introduce new service offerings, and make cuts to those that have been commoditised. For professional services firms, the challenge is to offer services that deliver customer success in a way that minimises the need for additional resources.

1 This figure excludes services that are out-of-scope for this report, such as computer systems design (covered in a previous report), scientific research, veterinary science, and professional photography services.

And finally, they need to be agile. In the first instance that means having access to technology and critical skills. In the second, it's about combining these to deliver the services that the customer wants. In that regard, the shift towards more flexible organisational structures dominated by multi-disciplinary teams that take end-to-end accountability for service delivery is the way to go.

Outlook.

As at the beginning of 2022, New Zealand has moved into a new phase of the Covid pandemic. With New Zealand's eligible population now mostly vaccinated, the emergence of a more contagious variant has prompted a shift away from the previously elimination strategy. While public health measures may now be dialled up and down as necessary, we are unlikely to see the sharp swings in economic activity evident in 2020 and 2021.

The recent outbreak of the highly transmissible Omicron variant is likely to dampen economic growth in the short term, although activity levels are expected to firm once it has passed. Firming economic activity should be good news for the professional services sector over the coming year. That is especially so given that it typically outperforms the rest of the economy, even during a downcycle.

Indeed, customers that had previously hit the "pause" button on projects should be feeling a bit more comfortable about spending in an environment where the risk of being locked down is lower. That in turn is likely to mean more advisory work for business/accounting/financial and commercial law advisory service providers.

The focus of these services is likely to be twofold: a) improve organisational resilience to external shocks; and/or b) take advantage of any opportunities that might present themselves in a post Omicron world. Indeed, in the near term some customers will be looking to rearrange their operations, seeking advice on how to better integrate their people and processes. Others will be looking to take advantage of firms that have struggled to sustain themselves through the Covid storm and are easy pickings for mergers and acquisition activity.

For some professional services firms, the passage of Covid is likely to have little impact. That is certainly true for the many small accounting firms that provide basic services to customers seeking to comply with their statutory reporting requirements, although as mentioned in this report, automation is likely to close the door on many of these firms in the future. The need for accounting services will also have been helped by firms having to account for Government fiscal support during the pandemic, although that requirement is likely to fall away over the coming year.

Meanwhile, with a strong pipeline still in place, construction activity is set to remain elevated over the coming year, and that should support demand for engineering and architectural consulting services. Not so for property conveyancing firms, who are likely to see transaction volumes drop as activity in a hitherto strong housing market slows.

Longer term, we think that professional services are in for a turbulent time.

As Covid becomes normalised, we expect demand for professional services will return to historical patterns from 2023 onwards. Customers will continue to spend on services that help them get ahead of their competitors. Indeed, failure in this regard means that they will get left behind. Most of the spend is likely to focus on getting the best out of new digital technologies, which will continue to transform existing work organisation methods.

Other growth areas are likely to include providing advice on environmental, social and governance issues. Indeed, we think that in coming years, firms will come under increasing pressure to ensure that their views on these issues align with those of stakeholders, customers, and employees. That will extend to firms being required to show that they have taken practical steps to limit their impact on the environment, have demonstrably supported efforts for greater diversity and equality, and have operated in a clear transparent manner. Similarly, a higher regulatory load, which reflects society's desire for less risk/more rules, is expected to provide an additional stream of work.

Some of the big trends affecting professional services firms are set to continue well into the future. Increasing customer expectations, rising competitive pressures and the ever-quickening pace of technology are going to accelerate change. That in turn is going to drive the sector up the value curve. Services will be increasingly automated and commoditised, including many today that require significant human capital expertise. But as technology takes away, it also gives, creating new opportunities for providers to add value to their customers.

We think that in the future, many firms will stop providing commoditised services. That will be difficult for many, but the profits are just not going to be there. The vast majority of those that still provide such services will outsource to software/IT vendors, but market them under their own brand name. Professional services firms that are not able or unwilling to outsource are likely to struggle.

The winners are likely to be those that are not only are able to access required human capital and technology but can combine them to deliver solutions that create extra value for their customers.

For large firms with deep pockets, that shouldn't be too much of a problem. Reputations count and they will continue to have first dibs on the "best and brightest". Even where shortages occur, talent marketplaces are likely to provide a handy way of filling skill shortages. Ditto for accessing digital technology, despite the inherent danger of being leapfrogged by newer technologies.

For smaller firms, having access to skills and technology is likely to be more of a challenge. For one thing they don't have the reputation that their larger counterparts have, so at best they are only likely to get the second bite of the "best and brightest" cherry. For them accessing skills is going to be more of a hybrid affair – half in-house and half talent marketplace. As such, they are more likely to run with virtual teams than larger firms, although that does not preclude these players from doing so.

Technology too poses an issue for smaller providers. The costs are likely to be prohibitive and ongoing, and well out of reach for most. To keep costs down, we think that smaller providers will increasingly procure technical infrastructure, platforms, and software as a service. Larger firms will procure some IT services on the same basis.

In summary, we think the sector will see a divergence. Large players will provide services by leveraging off their own internal resources, occasional dipping into external resources where necessary. By contrast, smaller firms are much more likely to operate a more agile distributed model where resources are mostly externally sourced, and then combined internally to deliver customer value.

However, while there may be a divergence, we also see some commonality. Increasingly we think that professional services firms, irrespective of size, will move to network-based models where multi-disciplinary teams hold end-to-end accountability for service delivery. Firms that operate this model will leave those that continue to use old-fashioned silo-based hierarchical models in their wake.

Introducing the industry.

Scope of this report.[2]

This report focuses on firms that provide professional services, with a specific emphasis on those involved in providing legal, accounting, architectural, engineering, management consultancy, advertising, and marketing services.

Services provided are typically intangible, knowledge-based, and range from the generic to highly tailored advisory services that encompass the transfer of knowledge or service from provider to customer. Rather than feeding into final consumption, the outputs generated from these services are inputs into other economic activities, and as such are largely dependent on the volume of these activities.

Legal services.

The primary service rendered by law firms is to advise clients, ranging from individuals to large companies, about their legal rights and responsibilities, as well as to represent clients in civil or criminal cases, business transactions, and other matters where assistance is sought, such as the preparation of legal documents. To that end, the knowledge of law and/or best practice informs legal opinion and recommendations that are specific to a client's situation and requirements. Legal services cover a wide range of disciplines from criminal law to commercial, property, personal injury, family, and intellectual property.

Table 1: Scope of this report

Professional services within scope
Legal
Accounting
Architectural
Engineering consulting
Management consulting
Advertising
Market research
Professional services outside scope
Computer systems design
Photography
Scientific research
Veterinary science

Source: Westpac

Accounting services.

Accounting firms provide a range of services, from bookkeeping and the preparation of financial statements and tax returns to the auditing of financial statements, assurance of financial processes and controls, and advisory services that aim to improve business performance at all levels of the firm. Some accounting firms also provide highly specialised services, including business valuation services, information system services (which examine the integrity and security of computer systems and employed data practices), as well as fraud and forensic accounting services. This sector was covered in detail in our Accounting services report.[3]

Architectural services.

Architectural firms plan and design buildings and other structures, develop land, undertake aerial surveying, engineering surveying, land surveying, as well as graphics and interior design. To that end, architectural services include design (pre-design, schematic design, interior design), modelling and programming, filing and permitting, construction administration and project management.

Engineering consultancy services.

Consulting engineering firms specialise in the planning, designing and technical work involved at each stage of a structure's lifecycle. Structures range from houses, industrial buildings and large office blocks to horizontal infrastructure such as roads and processing plants. Specific services include pre-feasibility studies, feasibility studies, basic studies, detailed engineering design, project management, procurement assistance, monitoring/supervision, inspection & expediting, testing, commissioning and if required, operation and maintenance for all types of projects, from civil, mechanical, and electrical to marine, mining, and hydraulics. Consulting engineering firms are commonly used by industries such as construction, automotive, telecom, energy, transportation, pharmaceuticals, and manufacturing.

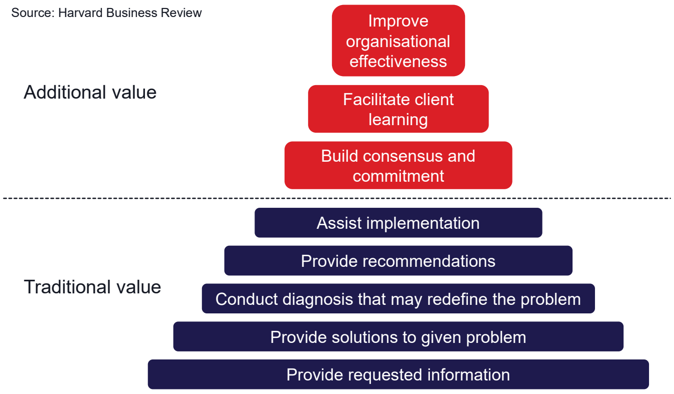
Management consultancy services.

Management consultancy firms are mainly engaged in overseeing, managing and exercising operational control as well as undertaking strategic or organisational planning roles on behalf of customers. Firms that operate in this market segment provide advice and strategies to solve a range of business-related issues, such as financial performance, operational management, corporate strategy, marketing, and sustainability. Industry operators service a wide range of markets, including financial and professional services firms, government entities and healthcare providers.

2 This report excludes firms and establishments that deliver scientific research, computer systems design (covered in our earlier report on the ICT sector: https://www.westpac.co.nz/assets/Business/economic-updates/2020/Other/Industry-Insight-Oct-2020-Westpac-NZ.pdf), veterinary science, and professional photography services. Also out of scope are practitioners who work for firms in other industries that operate in-house professional teams. That is particularly prevalent in legal, advertising, accounting and internal auditing services.

3 https://www.westpac.co.nz/assets/Documents/Business/Economic-Updates/2018/Other/Industry-Insights-Accounting-Services-Sep-2018-WEB.pdf

Figure 1: Hierarchy of consulting purposes



Advertising services.

Advertising agencies are involved in the creation of advertising campaigns and materials, media planning activities and the placement of advertisements across various media channels, from television and radio to online and mobile marketing. While advertising agencies typically operate independently from their clients, advertising professionals can also be found in other firms and industries where they provide a critical eye over their employers efforts to sell products and services. An agency can also handle overall marketing and branding strategies, as well as promotions for its clients.

Marketing research services.

Firms operating in this market segment are involved in the systematic gathering, recording, tabulating, and presenting of marketing data. The purpose of market research is to determine the viability of a new service or product based on the opinions and feedback provided by actual and potential customers through surveys, product testing and/or focus groups. Market research is typically undertaken by specialist businesses that operate independently from their customers. Alternatively, this activity may be undertaken in-house.

Professional services firms service all sectors of the economy, from private individuals to large corporates, public sector enterprises and government departments.

Recent performance of the sector.

Turnover of the sector.

Table 2: Turnover by market segment

Professional services	2020 estimated turnover ($bn)
Management consulting	8.0
Engineering consulting	5.5
Legal	3.9
Accounting	3.3
Architectural	2.9
Advertising	2.4
Market research	0.3
Total	**26.1**

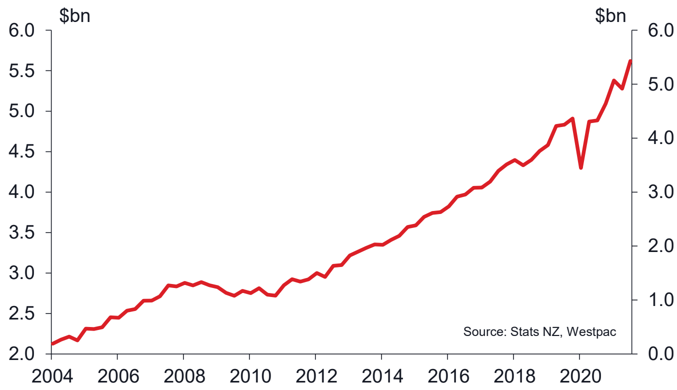
Source: Stats NZ, Ibisworld, Westpac

The professional service market segments covered in this report collectively generated revenues of about $26bn in 2020. They account for about 60% of total revenues from all professional services, which also includes computer systems design and related services which we covered in our earlier report on the ICT sector.[4]

Management consulting is the largest market segment covered in this report, generating revenues of about $8bn. Roughly $2.3bn of this was generated from consulting services focusing on corporate strategy, specifically the transformation of business models, while a further $2.1bn came from operational consulting services, with the emphasis on maximising business processes efficiencies. Other significant contributors to turnover include $1.3bn generated from financial consulting services that provide deeper insights on financial performance, and a further $1.1bn from consulting on marketing and public relations.

Engineering consulting services generated revenues of about $5.5bn in 2020. About $2.7bn of this was generated from advising and reviewing designs for civil construction, mechanical, electrical, marine, mining, and hydraulic projects, with a further $0.7bn coming from surveying, testing and analytical services, and $0.5bn from project management advice.

Figure 2: Quarterly industry sales – professional services



4 https://www.westpac.co.nz/assets/Business/economic-updates/2020/Other/Industry-Insight-Oct-2020-Westpac-NZ.pdf

Legal services generated revenues of about $3.9bn in 2020, about $0.9bn of which came from providing services to businesses and government and a further $0.7bn from services provided to families and individuals. Add to that $0.6bn each from property law services, mostly conveyancing, and other law services, such as legal services relating to intellectual property, environmental and constitutional law. Revenues generated from criminal law services were in the region of $0.3bn.

Accounting services generated about $3.3bn in 2020, just under two-thirds of which came from the preparation of financial statements and the completion and filing of tax returns. Revenues from auditing and assurance services were worth another $0.5bn in 2020, while a further $0.4bn came from advisory services.

Firms that provide architectural services, such as the planning and designing buildings and structures, or planning and designing the development of land, generated an estimated $1.3bn in 2020. Surveying and mapping services, ranging from aerial and oceanic to land surveying as well as map preparation, generated another $0.4bn, while other specialised design services, such as interior design, graphics design, and commercial art, generated an additional $1.3bn.

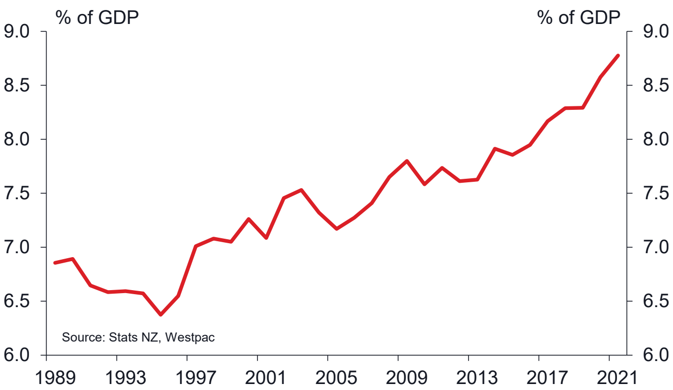
According to the Advertising Standards Authority, firms that provide advertising generated revenues of about $2.4bn in 2020. A further $0.3bn came from marketing research services. Of total advertising revenues, just over $1.3bn came from online advertising, with television, radio and newspaper advertising adding about $0.9bn. The remaining revenue came from outdoor advertisements, such as billboards, mail, and cinema advertising.

Meanwhile, revenues generated from providing market research services amounted to about $0.2bn in 2020. An additional $0.2bn was generated from statistical research undertaken by Statistics New Zealand.

Contributions to value added.

In terms of value added, the professional services sector contributed about 8.7% to New Zealand's GDP in 2021. That equates to about 13% of value added generated by all New Zealand's services industries. In value added terms, professional services are the second largest services sector in New Zealand.

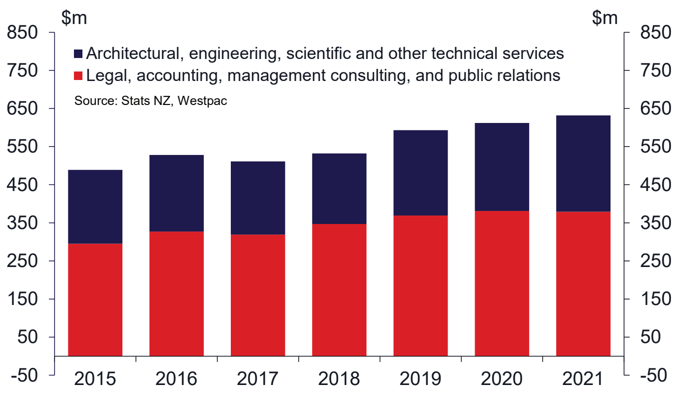
Figure 3: Contribution to GDP



The sector's contribution to GDP has trended higher over time. To a large extent that reflects the impact of slow burning structural changes occurring in the economy, not least of which has been the shift away from manufacturing towards knowledge-based services.

Exports.

Figure 4: Exports of professional services



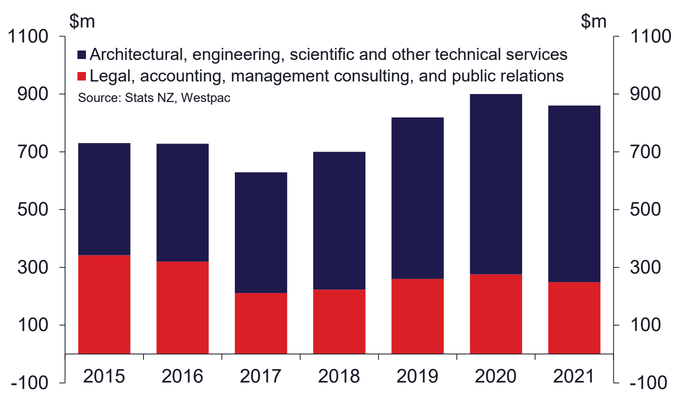
Professional services exports are small. For the year ending June 2021, they totalled $632m. In large part that reflects the highly fragmented nature of the sector, with most firms having neither the scale or brand recognition to successfully penetrate export markets.

About $380m of this was generated from the export of legal, accounting and management consultancies services, with a further $250m coming from architectural, engineering, and other technical services.

Although small, professional services exports have grown strongly in recent years, increasing 28% between 2015 and 2021. The performance of exports largely reflects increased economic activity in key export markets, as well as the opportunities and risks facing firms that operate in these countries. More recently, demand has been driven by the need to be more resilient to external shocks.

Imports.

Figure 5: Imports of professional services



According to Stats NZ, New Zealand imported just under $900m worth of professional services in 2021, about two-thirds of which was for legal, accounting and management consulting services. We estimate that imports of architectural, engineering, and technical services accounted for a further $250m.

Imports of legal, accounting and management consulting services have grown by 57% since 2015. Import growth largely reflects the increased amount of work secured locally but outsourced to low-cost centres in other countries. Also included are niche services not provided locally.

By contrast, imports of architectural, engineering, and technical services have declined by 27%. Reasons for this decline are not immediately clear but are likely to reflect the competitiveness of domestic service providers that benefit from being local and have situational expertise.

In some cases, imports have grown because of the recognition of standards set in New Zealand. For example, in 2017, the United States, Australia and New Zealand established an arrangement to mutually recognise registered architects through each country's system. In turn, this has contributed to a rise in foreign operators providing design services in New Zealand.

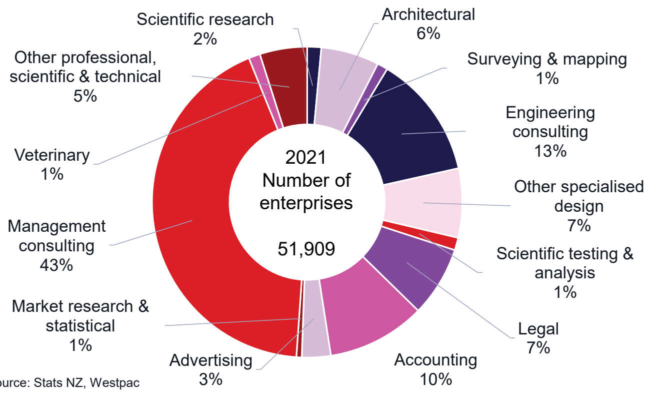
Shape of the sector.

Firms.

Almost 52,000 enterprises operate across the broader professional services sector. That shrinks to about 43,000 firms for the market segments covered in this report.

Of these, about 22,000 firms provide management consultancy and related services, mostly advice on corporate strategy, organisational planning, marketing, human resources, and operational management issues. A further 6,700 enterprises deliver engineering design and consulting services, most of which focus on advisory and quality assurance.

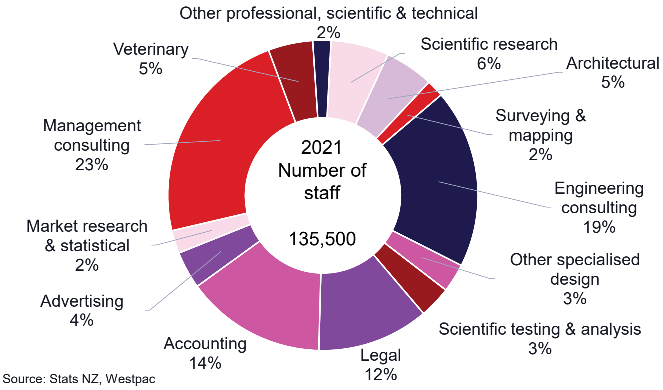
Figure 6: Number of enterprises by sub-sector



Source: Stats NZ, Westpac

In 2021 there were about 5,300 accounting firms operating in New Zealand, providing a range of services from basic accounting to auditing and advisory services, while a further 3,800 provided a range of legal services to businesses and individual households. In addition, a further 3,700 firms provide specialised design services ranging from graphics to interior design, while about 1,600 provide advertising services. The sector also hosts about 200 or so statistical service entities, the largest of which is Stats NZ.

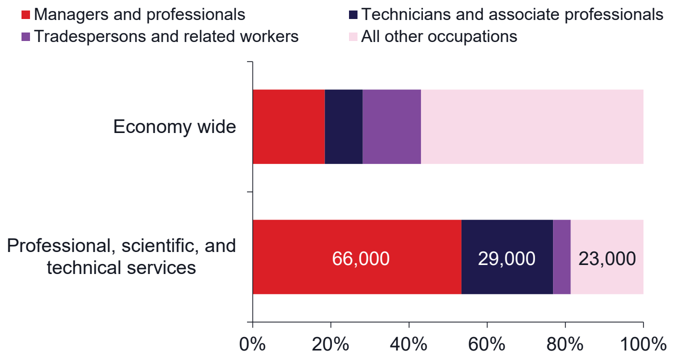
Figure 7: Number of employees by sub-sector



Source: Stats NZ, Westpac

The broader professional services sector employs almost 136,000 people. That falls to about 114,000 for the market segments covered in this report. The management consultancy market segment is the largest employer in the professional service sector, employing about 31,000 people. They are followed by engineering consulting firms that collectively employ a further 25,200 people. An additional 20,000 and 16,000 people are employed in the accounting and legal services sub-sectors respectively, with a further 5,400 providing advertising services.

Figure 8: Employees by skill category



Source: Stats NZ, Westpac

A key feature of the professional services sector is the relatively high proportion of managers, professionals, and technical staff that work in it. Collectively they make up 76% of staff employed in the sector, compared to 28% in the economy as a whole. That's not surprising considering that professional service firms are in the business of selling proprietary knowledge.

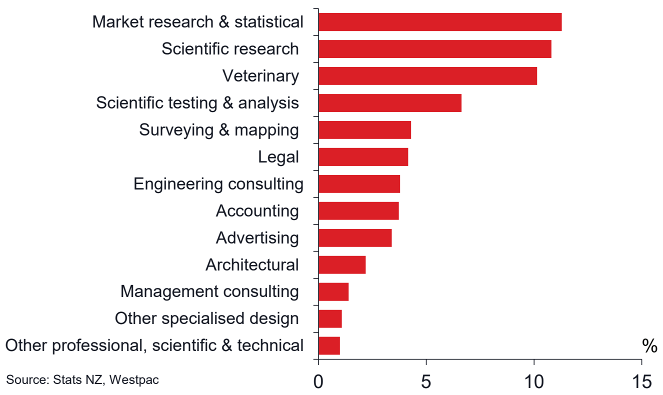
The profesional services sector is knowledge-intensive and relies on the skills, competencies and knowledge of its people.

Degree of fragmentation.

The professional services sector is highly fragmented. Indeed, the average size of a professional service firm in New Zealand is just 5 people. This drops to just over 3 people when out-of-scope market segments are excluded.

We estimate that up to 50% of these are sole operators, while another 40% are small firms either equity owned or managed by one or two senior partners. These firms are typically confined to specific practice areas and/or activities. For example, a small legal firm may specialise in family law and might only provide legal advice, while another small firm might focus on commercial law with an emphasis on litigation services.

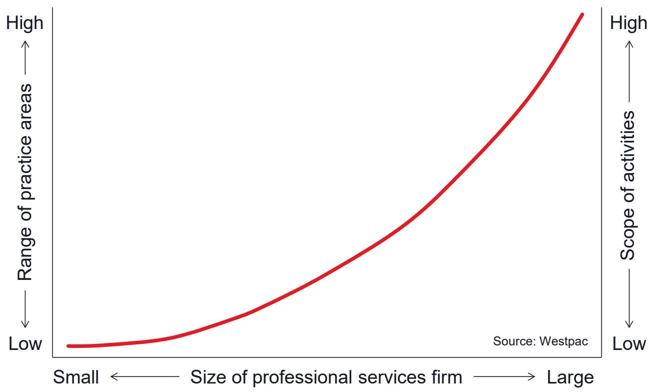
Figure 9: Employees per firm by sub-sector



Just under 10% of professional service providers are mid-sized firms that have at least two partners, who focus on a range of different practice areas and specialist activities.

The small number of firms that remain are large operators that provide a wide range of services across many different practice areas. They typically have many partners, who are tasked with leading specific practice areas. Some of these firms are homegrown and are leading players in their specific market segments. Others are multinational behemoths that can access global expertise to deliver innovative solutions to local customers. That includes the "big four" accounting firms, which provide management consultancy and accounting services, ranging from the very simple to the highly complex, primarily to the top end of town.

Figure 10: Nature of professional services firms



Tiering.

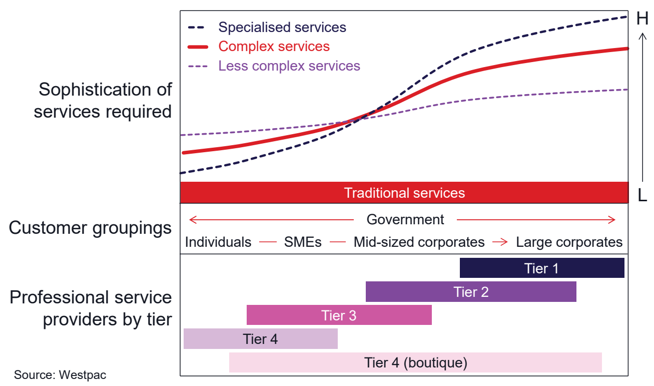
When assessing the nature of professional services sector, it is useful to distinguish between four distinct tiers of service provision.

Tier 1 firms include global behemoths and other mutinationals that deliver a wide range of services across different market segments and practice areas. Examples of the former include the "big four" accounting firms – PricewaterhouseCoopers, Deloitte, KPMG and Ernst & Young – which provide a diverse range of accounting, auditing, tax, legal and management consulting services, mostly to top-end corporates, government and public insitutions. Although smaller than the "big four", firms like Grant Thornton NZ, BDO and Accenture are also part of larger international groups that deliver a wide range of services across different market segments and practice areas, mostly to medium to large-sized corporates.

Tier 2 firms include multinationals and large local firms that deliver a wide range of services across different practice areas but within rather than across given market segments. Examples include BECA and AECOM, both large multinational firms that provide engineering and related environmental consulting services to a range of clients, including medium and large corporates and government. Also included would be the likes of Tonkin Taylor, a large local engineering consulting firm (with some offshore interests) that provides services across many different practice areas such as geotechnical, civil and transport. The same applies to large local firms, such as Warren and Mahoney, which provide a range of architectural services to residential and non-residential developers, government and public institutions. Also included would be the likes of Chapman Tripp, Russel McVeigh, and Bell Gully, each of which deliver a range of legal services across many practice areas, and Martin Jenkins and Tenzing, both of whom are large local management consulting firms.

Tier 2 firms compete head on with Tier 1 firms for the business of medium-sized to large corporates, but not when it come to servicing the top end of town. Tier 2 firms also compete for SME business, targeting those that have more sophisiticated needs.

Figure 11: Provision of professional services by tier



Meanwhile, Tier 3 firms are mostly locally domiciled medium-sized firms that deliver specialist services across a narrowing range of practice areas. Examples include Auckland-based Engineering Design Consultants. They compete head on with Tier 2 firms for the business of medium-sized businesses as well as SMEs that have more complex needs. They also compete with Tier 2 firms for the business of mid-tier corporates, especially those with less sophisticated needs. Tier 3 professional services firms also compete for the business of individuals/families/trusts.

Tier 4 firms are typically very small local firms, mostly owner-operators that provide a narrow range of services within a single practice area, primarily to other small firms, individuals and families. That includes firms that provide traditional accounting and legal services, as well as firms that provide graphic design services. Some Tier 4 firms are also boutique service providers, which provide specialised services to a wide range of customers, including large corporates.

In addition, there are individuals that provide limited services at discounted prices. That is particularly prevalent in market segments such as accounting services, where "across the kitchen table" providers deliver simple bookkeeping and tax return services, but would also extend to other areas of the professional services sector, such as legal and graphic design services.

The practice spectrum.

Professional service firms operate along a spectrum of sophistication. At the one end of the spectrum are what the Harvard Business Review (HBR) refers to as "commodity" and "procedure" service providers, while at the other end are "grey hair" and "rocket science" providers.

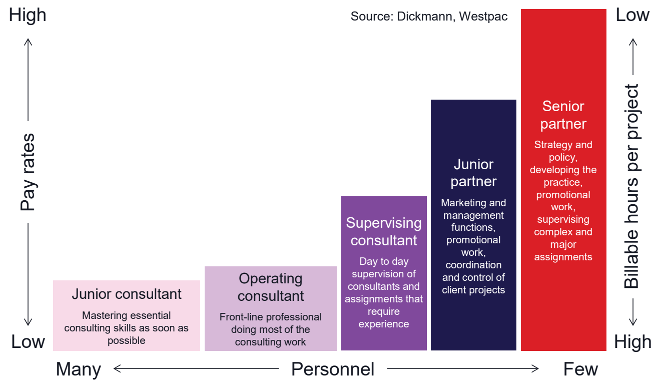
According to the HBR, a "commodity" service provider helps customers address simple routine problems by leveraging off already existing off-the-shelf solutions while "procedure" service providers offer systematic and standardised approaches to large and complicated problems. So-called "grey hair" service providers deliver high-end advice that leverages off extensive experience and comprehensive empirical analysis and testing. Meanwhile "rocket science" service providers deliver solutions to address gnarly problems that threatens client prosperity but can be addressed through deep expertise and innovative solution development.

It is important to note that a professional services firm can operate at different points in the spectrum. Other than Tier 4 service providers (including boutique providers), professional services firms can offer "commodity" services alongside "grey hair" or "rocket science" ones. However, there is a limit to this, and firms must be careful that they do not spread themselves too thinly. While most Tier 4 firms provide "commodity" or "procedure" services, their boutique counterparts typically deliver "grey hair" and "rocket science" services.

Traditional professional services model of delivery.

Most professional service firms in New Zealand adopt a hierarchical model of service delivery with a clear distinction being made between senior level staff, typically equity/managing partners responsible for developing and maintaining customer relationships as well as providing high-level project oversight; middle-level employees, typically experienced professionals responsible for day-to-day supervision and the coordination of projects; and junior employees, who typically perform the technical/analytical tasks required to complete a project.

Figure 12: Hierarchical model of service delivery



Most Tier 3 and above firms in New Zealand adopt a top-down hierarchical structure. Typically, they run specialised teams that operate independently in silos and are organised along clear production lines. That though is beginning to change as competitive pressures increase, and disruptive technologies push professional service providers towards more flexible network models that allow for greater collaboration and innovative thinking.

Table 3: Professional services end markets

	Commodity	Procedure	Grey hair	Rocket science
Selling proposition	Low cost	Systemic & comprehensive approach	Track record of dealing with similar problems	Ability to solve complex and bespoke challenges
Organisational capabilities	Efficient delivery processes	Well proven methodologies Knowledge management capabilities	Learning from experience Knowledge management capabilities Rigorous empirical analysis and testing	New theoretical approaches Rigorous empirical analysis and testing
Professional skills	Focused execution against detailed mandate	Rigorous following of established procedures	Converting knowledge to judgement applicable to other situations	Using new theoretical and empirical tools to deliver innovative solutions

Source: Harvard Business Review, Westpac

Demand drivers.

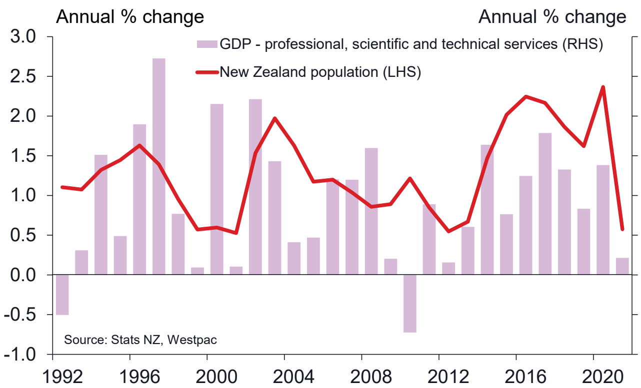
Demand for professional services is driven by a wide range of demographic, economic, legislative, environmental and social factors. Digital technologies though are the key disrupter, boosting demand for professional services while simultaneously raising the expectations of an increasingly sophisticated customer base.

General.

The professional services sector is subject to many demand side drivers. Some are long-standing and have a slow burning effect. That includes factors such as the structure of the New Zealand economy, with sectoral contributions to GDP dictating what type of services are in demand. For example, the services required by firms operating in the financial sector typically differ from those demanded by manufacturers, and those needed by farmers.

Also included here are population dynamics. Simply put, the more people (and firms) there are, the greater the demand there is likely to be for professional services. That's particularly relevant for family law, which covers everything from trusts to matrimonial matters, and criminal law services.

Figure 13: Professional services growth in value add compared to population growth

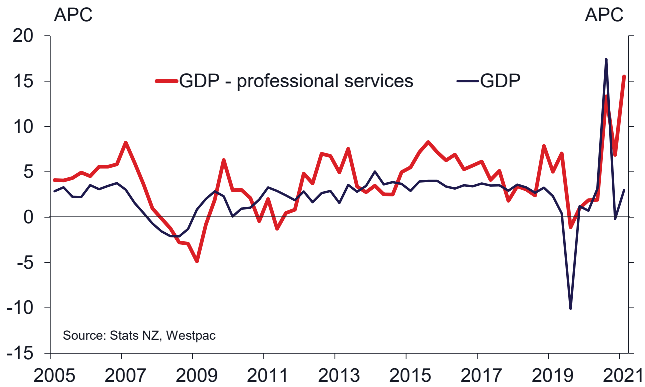


Demand for some professional services is also driven by the need to comply with the laws of the land. Indeed, a higher regulatory load which reflects society's desire for less risk and more rules is a big opportunity for professional services. That is certainly so for legal services, the very basis of which is to test whether actions/activities contravene the law. However, it is also true for traditional accounting and tax services, where firms are expected to comply with the Financial Reporting Act 2013 and the Tax Administration Act 1994, which specify who is required to produce financial reports, and what level of reporting is required.

Other long-standing drivers tend to have cyclical effects on demand for professional services. That includes changes in the economic cycle, which heavily affects the composition of services required. For example, during a downturn, firms typically seek accounting services that help them keep their head above water. Where that is not possible, they may look to their accounting providers to advise on how best to liquidate.

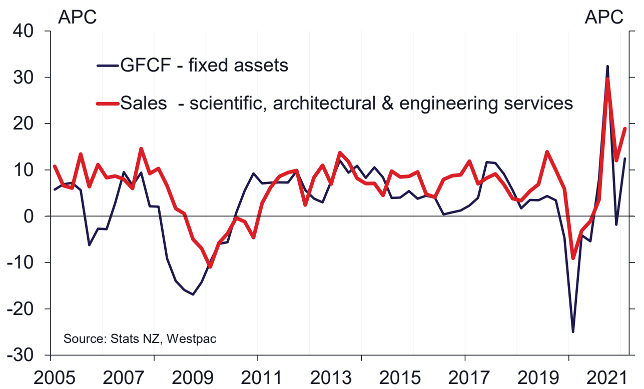
The opposite is true when the economy expands. When that happens, firms look to their service providers to help them take advantage of new opportunities. That is likely to explain why the sector tends to outperform the overall economy. Indeed, the sector is often described as being "recession proof", despite having contracted during the Global Financial Crisis.

Figure 14: Professional services growth compared to GDP



It's also true that the fortunes of some professional services are more closely tied to specific downstream industries than others. For example, demand for architectural and engineering consulting services is tied to activity in the building and construction industry. Engineering consulting services are also in demand from manufacturers looking to maximise the return on investments made in new equipment and machinery or to re-engineer existing work organisation methods.

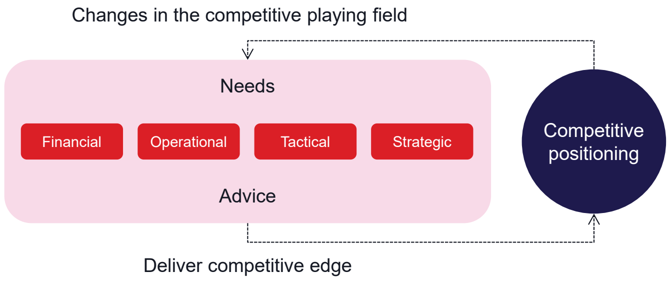
Figure 15: Investment in fixed assets vs architectural and engineering services



Competitiveness.

At a micro level, firms purchase professional services to improve their competitiveness. A 2020 report by the US-based Hinge Research Institute showed that the percentage of customers in the US who viewed their professional service providers as highly important to solving their business challenges increased by 108% between 2013 and 2020, and by 33% between 2018 and 2020.

Figure 16: Link between competitive positioning and advisory services



Source: Westpac

Indeed, without these services, these firms risk being left behind by more productive peers. Furthermore, that risk is becoming larger, as rapidly advancing digital technologies, increasingly important environment, social and governance imperatives, and changing legislative landscapes, combine to reshape the nature of competition in downstream industries.

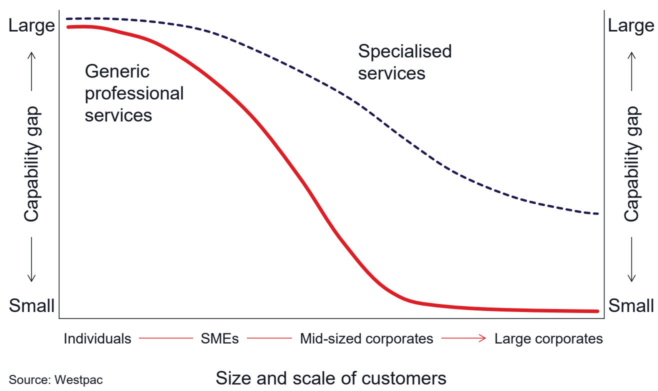
To remain competitive in a rapidly changing environment, firms require independent professional advice.

Capability gaps.

Firms also procure professional services because they have capability or expertise gaps.

Capability deficits apply to all firms, but are most evident in small, medium-sized enterprises and mid-tier corporates, which are not large enough to justify having in-house capabilities.

Figure 17: Capability gaps and the complexity of firms



Source: Westpac

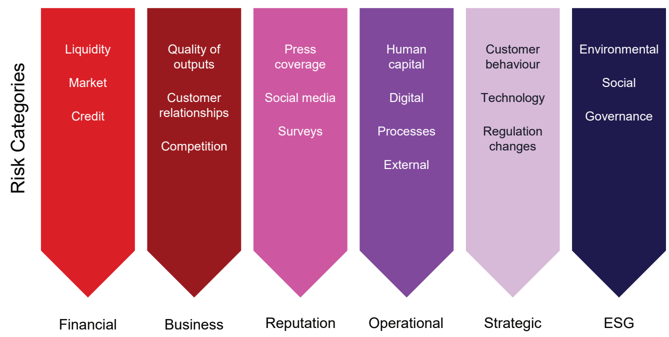
Capability deficits are often by design. It's not unusual, for example, for firms to procure services deemed to be non-core or seldom needed. Ditto for services that might be costly to undertake in-house because they require specialised skills that are in short supply or because they require heavy investment in technical infrastructure. Even larger firms that run their own in-house teams often lack the required expertise in highly specialised areas, so opt to outsource these instead.

Important activities deemed to be non-core underpin demand for professional services.

Management of risk.

Firms also procure professional services to manage risk. Construction firms for example, require structural consulting engineers to assume responsibility for the structural integrity of the projects they undertake, and as such take on the risk of infrastructure failure and the possibility of future litigation should that eventuality unfold.

Figure 18: Risk management categories



Source: Global association of risk professionals

They are not the only ones. Auditing firms can be held liable if it can be shown that a customer's audited accounts do not accurately reflect reality. Similarly, a source in the legal industry noted that they bear the risk of future litigation if advice previously provided forms the basis of a dispute.

They could also be held liable for a client's financial losses because of the advice they gave. To that end, many legal firms take out professional indemnity insurance to protect against claims that might result in severe financial losses. Under the Lawyers and Conveyancers Act 2006, insurance is not a compulsory requirement for lawyers other than property conveyancers, but is recommended. That is different to the practice followed by other countries such as Australia, where professional indemnity insurance is mandatory.

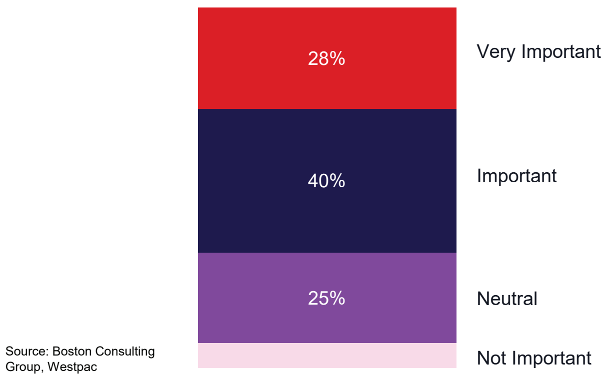
There are other areas where professional services firms take on risk. Customers are increasingly looking to their providers to share in the risk of non-delivery. That happens when the services provided by professional service firms do not deliver anticipated outputs or outcomes. In extreme cases, having "skin in the game" can result in the provider taking a financial hit.

Environmental, social and governance.

Downstream firms also use professional service providers to help improve their environmental, social and governance (ESG) credentials. Today, diversity, climate change and broader environmental sustainability issues, as well as demands for greater transparency, particularly from end consumers, are prompting many firms to take a harder look at their business practices.

For many, improving ESG credentials are an important way of managing risk and brand reputation. That is particularly so for firms that rely on shareholder support and have a solid investment backing. Indeed, markets are increasingly allocating capital on this basis. The recent invasion of Ukraine by Russia is a case in point, with many mutual funds selling off their holdings in Russian companies, sending stock prices plummeting in that country.

Figure 19: Employee survey of the importance of ESG activities



There are other reasons for having a position on ESG. Increasingly firms are finding it helps them recruit the best talent. Indeed, empirical evidence shows that millennials and Gen Z are more likely to favour employers that align to their own values and worldviews, are purpose driven and are seen to be doing "good". A recent survey of about 1,000 New Zealand employees undertaken by the Boston Consulting Group showed that 68% of respondents thought it was important or very important for organisations to focus on ESG activities.

Increasing revenue growth is another key reason. Firms are finding that their buyers are increasingly choosing vendors that are aligned to their own thinking on ESG, which in turns aligns with what their customers hold dear. To that extent ESG credentials are seen as a way in which companies can differentiate themselves and gain a competitive edge.

Should they not align, these firms risk the possibility of a backlash and a potential loss of revenue. The importance of ESG alignment is reflected in a 2021 study by IBM, which showed that 60% of consumers surveyed were willing to change their shopping habits to reduce environmental impacts. Furthermore, over 70% of those that showed a willingness to change were also willing to pay an average premium of 35%.

ESG is a key growth area for professional services firms.

Firms have little choice in how far they pursue an ESG agenda when they are required to comply with regulation/legislation. Pertinent here is the Financial Sector (Climate-related Disclosures and Other Matters) Amendment Bill, which when enacted will require about 200 financial organisations, listed companies and Crown financial institutions in New Zealand that are considered to have a higher level of public accountability when it comes to combating climate change, to identify and report on the impact of climate change on their organisations. Subject to the publication of climate standards, disclosures will be required from 2023 onwards. Over time these are likely to align with global standards set by the soon to be formed International Sustainability Standards Board.

Just a decade ago, there were only a few professional services firms focusing on sustainability issues. Today though the growing importance of ESG has made it a fertile ground for many in the professional services sector. That includes accounting firms that provide reporting services, legal services that focus on transparency issues, management consulting practices that help shape strategies and implement non-performance management frameworks to track progress towards ESG goals and objectives, and environmental consultants that advise customers on how best to reduce their carbon emissions and minimise adverse impacts on natural ecosystems. Also included would be engineering consultancies that advise on sustainability and rehabilitation practices and architectural firms that incorporate ESG principles in their designs.

Technology.

Technology is a key driver of demand for professional services. Digital technologies such as automation, digital platforms, artificial intelligence (AI), the Internet of Things (IoT), cloud computing, blockchain and chatbots are all disrupting the competitive environment in which consuming firms operate, and that is driving demand for professional services.

Digital Index score for New Zealand firms.

MBIE's Better for Business Digital Index score for all firms in New Zealand showed that despite some improvement there was still considerable room for firms to improve their digital capabilities.

In December 2021, New Zealand business posted an index score of 58/100, which was up on the baseline score of 51/100 recorded at the end of 2020. This improvement reflects increased digital confidence and motivation, greater use of productivity enhancing tools such as online communications and cloud-based services as well as increased online visibility and activity.

Businesses in New Zealand have generally been slow to adopt these technologies despite having access to world class infrastructure that delivers high speed broadband. That though is beginning to change. Indeed, a recent MBIE survey of digital readiness confirms that digital capabilities are increasing, despite ongoing security concerns and a lack of relevant skills. That is further confirmed by data provided by the Bank of New Zealand (BNZ), which suggest that spending on cloud-based services and having a social media presence has grown strongly over the past 4 years.

Downstream firms are embracing technology to gain a competitive advantage.

Increasing digital capability is creating new sources of revenue for professional services firms. Growth in digital adoption, for example, has driven demand for legal services that deal with issues such as privacy, procurement, employment, and intellectual property law.

However, it is also closing off other sources of revenue. Examples include the adoption of cloud-based accounting software, which has reduced demand for traditional accounting services. An industry source suggested that a major software provider in New Zealand has proposed automating tax returns to the Inland Revenue Department (IRD), further reducing the scope for basic tax services.

At the same time, digital technologies are providing customers with easier access to information as well as a widening choice of providers. That in turn is giving rise to two related dynamics. The first is an increase in customer sophistication, which is helping to raise service delivery expectations. Customers now have a much better understanding of what professional services can deliver than they used to. The second is an increase in competition, with customers more easily able to compare services offered by competing providers.

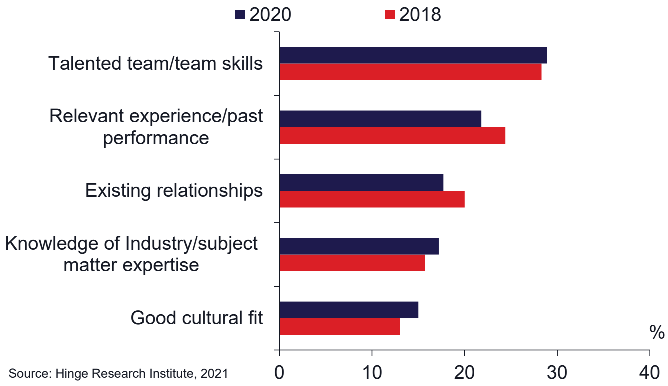
Rising demands and expectations are putting pressure on professional service providers to be faster and more agile.

Micro-level decision-making factors.

Service selection criteria.

The factors listed above determine the level and composition of demand for professional services at a macro level. However, when firms and individuals procure professional services, they also consider a diverse range of factors at the micro level. Typically, these relate to price, the skills, competencies and knowledge of those providing services, established relationships, perceptions of value, past performance, and reputation. To all intents and purposes these factors form the basis of competition.

Figure 20: Top 5 deciding factors for selecting a professional service provider



Source: Hinge Research Institute, 2021

The importance of these factors depends on the type of services that are needed. For commoditised services where there is little or no point of service differentiation, price is typically the key determining factor in procurement decisions.

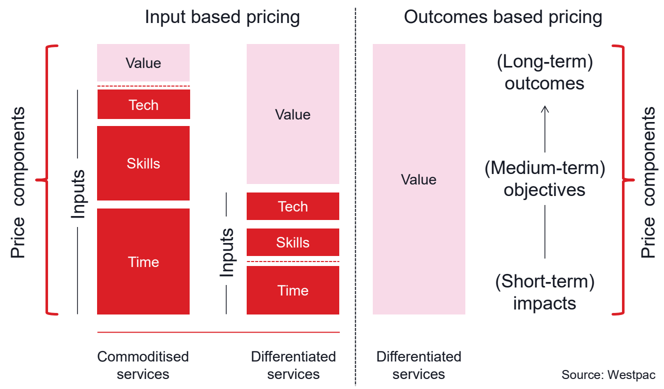
By contrast, customers that seek bespoke innovative solutions typically make their choice on the ability of their provider to deliver the most value. To that end, procurement decisions are primarily based on the capacity and the capability to deliver, with the former referring to the quantity of human and technological resources available. The latter, which refers to the quality of these resources, encompasses aspects such as the quality of technical infrastructure as well as skills, competencies, subject matter expertise and relevant experience. As mentioned earlier, customers are increasingly considering ESG credentials, which includes aspects such as good cultural fit and ethics.

Price is still a consideration for those seeking a bespoke solution, but it tends to carry less weight than it does for customers seeking a commoditised solution.

Input versus outcome pricing.

Traditionally, prices have been set on an estimated time and materials basis (referred to as billable hours), plus a margin (which essentially equates to value). Often referred to as input-based pricing, most professional services in New Zealand are priced on this basis, irrespective of whether they are commoditised or differentiated.

Figure 21: Components – input vs outcomes based pricing



Source: Westpac

While input-based pricing has the advantage of being relatively simple to understand and easy to apply, it's not without its faults. Indeed, input-based approaches have often been criticised for not considering the outcomes sought by customers that procure professional services, or the risks they bear should the service not deliver the benefits originally anticipated.

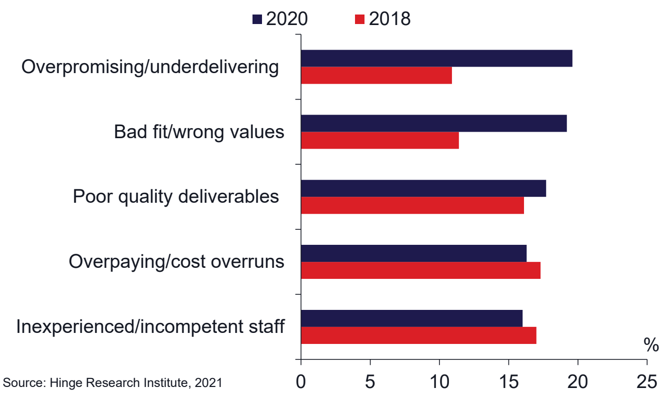
Input-based pricing models play little heed to demand, the competitive threats posed by others and outcomes sought by the customer.

However, as customer expectations have risen and competitive pressures in the professional services sector have increased, providers are starting to shift to an outcomes-based pricing model, where rather than being a function of inputs, price is based on the ability to deliver outcomes agreed earlier on. Under this arrangement, service providers benefit handsomely if results meet or exceed expectations, but face a potential loss of revenue if these are not realised.

Outcomes-based pricing is not without its challenges either. For one thing, outcomes-based pricing models require a high degree of trust between customer and service provider. While relationship management is a key competency of many professional service providers, gaining this level of trust implies a more resource-hungry partnership approach, which requires that service providers partner with customers to deliver required outcomes.

Secondly, what constitutes an agreed outcome can still be open to interpretation. That in turn creates the potential for overpromising and underdelivering, cost overruns and the delivery of poor-quality services – all of which are major concerns for customers when selecting a professional service provider. To mitigate this risk, professional service firms typically implement non-financial performance management frameworks that track progress on agreed key performance indicators.

Figure 22: Top 5 concerns when selecting professional services firms



Source: Hinge Research Institute, 2021

Value-based engagements are increasingly linked to performance and business outcomes sought by the customer.

Thirdly, it's not always clear how a particular project contributes to a specific outcome, especially over an extended period of time. While customers often expect professional services to deliver benefits to the financial bottom line, attribution is not always clear, especially when obscured by other factors.

Customers select their professional service providers on a subjective view of their ability to deliver intangible benefits.

Supply drivers.

Technology is disrupting the professional services sector, resulting in big changes in what and how services are delivered. That in turn is intensifying demand for skills, competencies, and knowledge in an environment where shortages are already evident. Technology offers a solution, with firms increasingly tapping into talent marketplaces to address workloads.

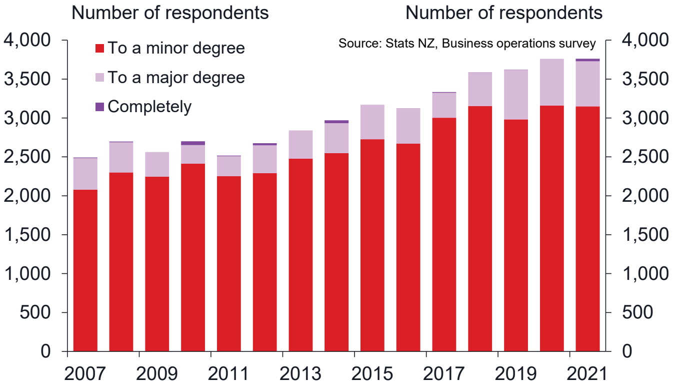
Digital technologies.

Propensity to adopt.

Professional service firms have often been seen as slow adopters of technology. According to a 2021 Hinge Research report, only 12% of professional services firms in the US have undergone digital transformation, while another 57% haven't moved beyond the planning stage. An industry source suggested that most professional service firms in New Zealand had only scratched the surface on moving to a digital future. That's backed up by a recent survey of small business in the Asia Pacific region undertaken by CPA Australia, which showed that businesses in New Zealand were less digitally savvy than those in other countries.

This hesitancy may in part be explained by the risks faced by firms that adopt and integrate these new technologies into their knowledge intensive activities. Studies show, for example, that applying digital technology indiscriminately can have a significant negative impact on customer perceived value. Indeed, a successful integration typically requires having a well thought out digital transformation strategy, which is likely to be out of reach for many small operationally focused providers.

Figure 23: Extent to which technology is adopted among professional services firms



However, there are signs that things are beginning to change. A recent survey undertaken by Salesforce in the US showed that 87% of professional services leaders in that country had seen a speeding up of their digital transformation since 2019. That compares to an average 79% across other industries. A similar trend has been evident in New Zealand in recent years with an increasing number of providers, albeit still in a minority, implementing major technological change.

Digitisation of operational execution.

To date, most of the investment made by professional services firms in digital technologies has focused on improving operating efficiencies and taking cost out of the system. That includes implementing process and cloud computing technologies that automate repetitive, tedious, and time-consuming tasks, which are typically undertaken by junior staff. At the same time, tools that embody data analytics and machine learning are being used to shift these displaced people into higher value tasks, helping them to learn, think and perform better than ever before. According to a source in the legal sector, firms that have automated have seen a 50% to 100% increase in throughput without the need for additional staff.

Investment in digital technologies has enabled professional services firms to automate, streamline, and eliminate many manual processes.

Digitisation of service execution.

Digital technologies are also being used to manage various aspects of project/service delivery, from marketing and real-time bid management all the way through to procurement, project management and service implementation. The focus here is not on reducing costs per se, although they are likely to yield savings, but rather on being responsive to customer demands. To that end, professional service firms are using technology to help leverage historical data from past proposals to dramatically improve their bidding process, not only in terms of the accuracy but also the speed with which proposals can be made.

Digital technologies adoption.

Chatbots are being used extensively in the professional services sector and they are being used increasingly to pre-qualify business leads.

One example is Parker, an Australian law firm chatbot developed to give basic answers to questions relating to changes to data protection and privacy laws before directing potential customers requiring further services to a menu of differently structured legal advice solutions.

Digitisation of customer positioning.

Professional service providers in New Zealand are also beginning to look at how they might use digital technologies, such as knowledge management tools, to shift the emphasis away from being product or service centric, where the focus is on operation and service execution, to becoming customer centric, where the focus is on achieving business outcomes sought by the customer. Put slightly differently, providers are increasingly being judged on the services that help customers get to where they want to be.

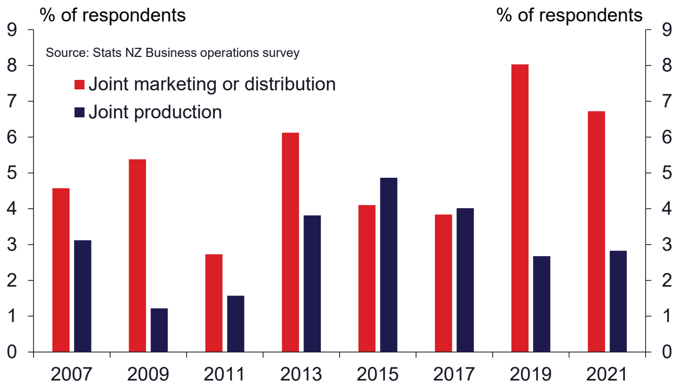
That in turn provides the basis for differentiation and the ability to shift from traditional input-based pricing based on billable hours to higher margin outcomes-based pricing, where prices reflect the extent to which customer business outcomes have been achieved. Under an outcomes-based pricing model, the professional service provider shares in the risk of a project/service not achieving stated business outcomes and stands to lose revenue if that occurs. That is particularly important given how quickly consulting recommendations are going out of date because of technology. Conversely, if the project or service achieves anticipated business outcomes, the professional service provider typically gains more revenue than would be the case under an input-based pricing model.

As margins fall for many traditional services, professional services firms are increasingly offering higher margin customer-centric services.

Digitisation of talent

Digital technologies are allowing for greater collaboration not just within firms, but also between firms that may be part of a consortium to deliver on a project. That is particularly relevant in construction projects where architects, engineers and builders collaborate with each other. An industry source suggests that as many as 85% of management consulting firms collaborate with others across the sector.

Figure 24: Collaboration between professional services firms in New Zealand



Professional service providers are also using technology to address skills gaps for projects. Increasingly, they are tapping into talent driven electronic marketplaces to create multi-disciplinary virtual teams which can then be deployed to address specific tasks. Traditionally marketplaces have been internal. For example, firms like Nestle, Google, IBM, and GE have been "internal talent machines" for many years. However, more recently there has been an increase in external marketplaces as demand for skills has grown and shortages have become increasingly evident. Most of these have been developed by IT firms, such as Reejig, an Australian AI company that uses big data, deep learning, and audited AI to help firms find, recruit, and move talent.

That in turn is helping professional service providers to tap into independent consultants and contractors that operate in the gig economy. According to a report from First Union, about 60% of workers that operate in the gig economy in New Zealand hold a tertiary qualification, with about 20% performing short-term jobs via "task" platforms. However, professional services firms are going a lot further, using the internet to access skills in other countries for work that can be done remotely.

The gig economy brings huge advantages and complementary skills to projects that may have traditionally struggled to find the same level of skills.

The increased use of technology to access skills to create virtual teams reflects a peculiar supply side dynamic that is evident in this sector.

Indeed, for many professional service providers, the quickest and most efficient way to address increased customer expectations (and gain a competitive edge) is to access new technologies and skillsets through mergers and acquisition activity (M&A). According to KPMG, global mergers and acquisitions activity in the professional services sector was worth a whopping US$280bn in 2020. And that is despite Covid. Furthermore, over the first 9 months of 2021, the value of M&A activity in the global professional services sector rose by 53% compared to same period in 2020. M&A in New Zealand is dominated by IT, media, and telecoms, although deal flow in finance and business, which presumably would include professional services firms, is also strong.

However, with M&A there is always the risk of overextending. Indeed, many professional service firms have found that as they have got bigger over time, their collective expertise has ended up being stretched across more and more people, locations, and practice areas, often to the point where service quality has been compromised. As a consequence, many of these overstretched firms have become "jack of all trades and master of none" that compete more on price than on service quality.

In a recent FT survey, two-thirds of respondents said that professional services firms are adding too many services, potentially diluting their core competencies.

Skills and competencies.

Changing skills requirements.

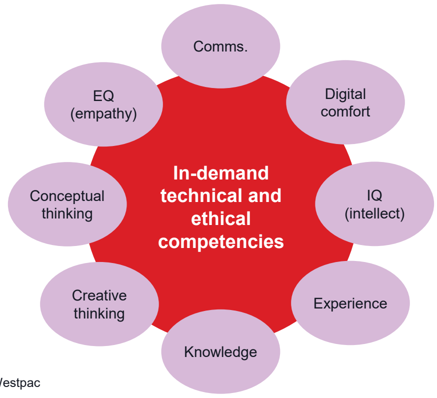
The professional services sector is labour intensive and relies heavily on having access to human capital that can deliver the expertise as well as organisational flexibility that customers require.

To that end, the skills, competencies, and knowledge exhibited by human capital largely determines the type of customers that a professional service firm will serve. What is also true, however, is that customers, by virtue of the services they procure, also influence how these skills, competencies and knowledge develop over time, which in turn reinforces the type of customers a professional service firm will serve in the future.

Firms in this sector are characterised by a high knowledge requirement, a professional workforce, and high labour intensity.

According to industry sources, firms in the professional services sector compete on skills, competencies, and knowledge. But that is only partly true. The reality is that firms compete primarily on their capacity and capability to do the work. That in turn depends not only on the quality and quantity of human capital but also the quality and quantity of technology that they are able to tap into.

Figure 25: Most valued competencies



Source: Various, Westpac

These two concepts are not mutually exclusive. The quality and quantity of human capital required by a professional services firm, for example, partly reflects the technology it can access. Providers are increasingly using digital technologies to automate repetitive and time-consuming tasks, and that is leading to resources being redirected towards higher value-added tasks that require a different set of competencies and skills. That is certainly true for traditional accounting service providers who have made the shift and are increasingly leveraging off digital technologies such as blockchain and AI, and the in-depth knowledge they have of their customer's financial standing, to provide advisory services. Such services, however, require skills and competencies that differ from those required to deliver traditional financial and tax services.

Indeed, the accountant, for so long simply a numbers person, is now becoming more of a people's person, with a broader range of softer relationship skills to complement already well developed technical and ethical competencies and problem-solving abilities. Being entrepreneurial, having strong business acumen and being able to think strategically are additional sought-after competencies. Specialist knowledge areas such as negotiating deals, M&A, shareholder disputes, due diligence, raising finance through debt or equity are areas where accountants can really add value due to their exposure to a broad range of businesses and transactions.

Similar dynamics are evident elsewhere. Management, architectural, engineering consulting and legal services firms have long recruited the "best and brightest". Traditionally that has meant hiring intelligent people with strong conceptual and creative thinking, problem solving, and communication skills. However, as new technologies have come to the fore and professional services firms have pivoted into higher value-added services, they are increasingly looking for people who have grown up under the influence of the internet and other technologies, as well as those that are culturally sensitive, are empathetic, environmentally conscious, and socially aware.

A recent KPMG study highlighted that accessing talent was the most significant concern for firms in the professional services sector.

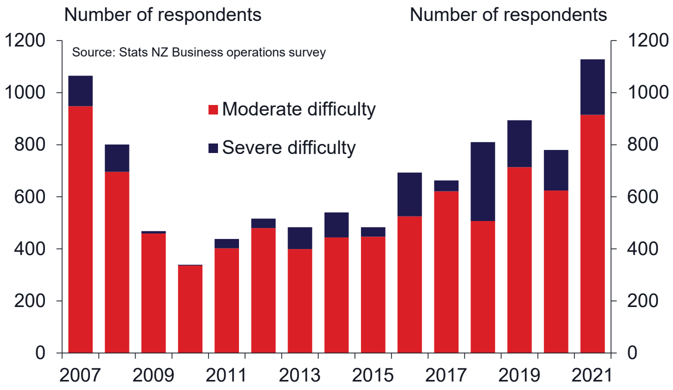
Deepening skills shortages.

Such skills though are in short supply. There are four reasons for that. Firstly, the "best and brightest" implies a level of scarcity even during the best of times. That situation has deepened as new digital technologies have come to the fore. The closure of the borders to skilled migrants in response to the Covid pandemic is likely to have increased this scarcity.

Secondly, professional services firms are facing increasing competition for skills from other sectors in the economy, such as financial and business services, which are going through a similar digital revolution. Add to that growing demand for skills from firms in other sectors that have their own in-house teams.

Thirdly, there has been a blurring of the lines of distinction between different market segments within the professional services sector, as providers have sought new revenue opportunities in response to rising competitive pressures. For example, engineering consulting firms are increasingly providing environmental consulting services that overlap those offered by environmental and management consultancy firms and are tapping into the same skillset to do so.

Figure 26: Professional services firms finding it difficult to access skills



Fourthly, regulation is limiting who can practice, at what level, and in what areas. Indeed, most market segments in the professional services sector have an industry body that registers or provides some form of accreditation. Examples include Engineering New Zealand which currently sets the standards for engineers to be accredited as a Chartered Professional Engineer (CPEng), Chartered Accountants Australia and New Zealand, which registers and specifies best practice for Chartered Accountants and Chartered Public Accountants, the New Zealand Registered Architect Board, which sets the minimum competency standards to be registered, and the New Zealand Law Society which is responsible for the licensing and oversight of those wishing to practice law in this country.

Shifting workplace practices.

Offsetting this to some extent is the well-publicised shift towards remote working. A recent KPMG study found that recruiting for new talent had changed as remote working had widened the potential talent pool. That is likely to have accelerated because of Covid, although there are limits, especially for tasks where social distancing is not possible. Indeed, according to Stats NZ, about 59% of people working in the professional services sector were likely to have worked from home during the initial lockdown in the second quarter of 2020. That puts it third behind finance (71%) and information media and telecommunications (65%).

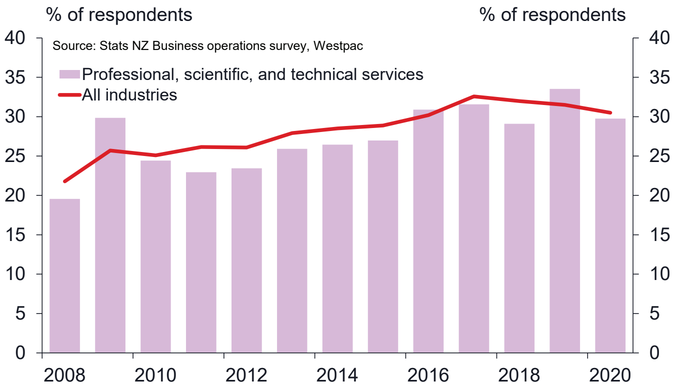
Also likely to have helped are the talent marketplaces referred to earlier, which enable professional service firms to access talent, which they then use to create multi-disciplinary virtual teams to address specific tasks. A Harvard Business School survey suggested that 90% of businesses in the US believed that on-demand platforms would be somewhat or very important to their firm's future competitive advantage.

Investment in capacity.

Professional services firms are also expanding their operations. According to Stats NZ, about 3% of firms in the professional services sector look to merge or acquire other firms in any given year, while up to 30% consider expanding their operations. That is roughly in line with industry as a whole, although that has not always been the case.

Not all firms are able to invest. Indeed, most firms that operate in the professional services sector in New Zealand are very small, cashflow dependent operations heavily focused on daily operational issues, with little ability or will to invest. That may go some way to explaining why professional service firms have lagged in adopting digital technologies.

Figure 27: Investment propensity of professional services providers



In addition, smaller firms are often unwilling to invest because they have in effect a 100% dividend policy, which sees all the profits going back to the equity partners. Investing in new technology implies that these partners take a financial hit in the short term for benefits that may only accrue in the long term, well after they have left the firm.

An unwillingness to invest may also reflect the age profile of those that own professional services firms. Many of them are older and have successfully operated their businesses over a long period of time, developing strong relationships along the way. However, many are also struggling with the pace of technology change, and having no succession plans in place, have opted to continue to operate as they always have done. With strong relationships in place, that is likely to be okay for a while, but as technology begins to squeeze their margins, these firms are likely to face an uphill struggle.

Investment in New Zealand's professional services sector from offshore has steadily increased over time. Indeed, Stats NZ's business operations survey suggests that a sizeable 14% of surveyed respondents experienced some investment from offshore in 2020. Motivations vary but include large firms looking to reduce concentration risk associated with specific geographies and allocating work to those are best suited to undertake it or where it might be most cost-effective to do so.

Figure 28: Cross border investment in professional services

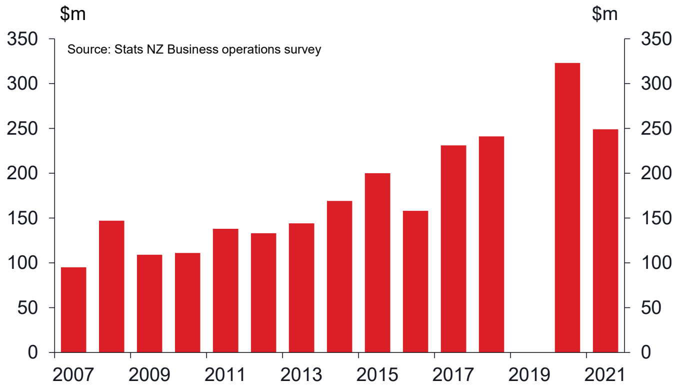
These reasons may also explain why outward investment by New Zealand based professional services firms has also tracked higher. Based on Stats NZ data, we estimate that the number of firms making an outward investment increased by a whopping 150% between 2007 and 2020. About 8% of New Zealand based firms made some sort of offshore investment in 2020, compared to about 4% back in 2007. Indeed, several sources that provide accounting and legal services suggested that they outsource basic services to firms that operate in low-cost countries. Similarly, an engineering consulting firm indicated that most of their grunt work was done overseas, leaving the higher end knowledge-based work to be undertaken in New Zealand.

Research and development and innovation.

New Zealand's broader professional services sector spends about $1bn a year on research and development (R&D). However, that includes just over $0.7bn in R&D spent by firms that are involved in computer systems design services, which are not covered by this report. The remaining $300m is also likely to include R&D undertaken by scientific research organisations (which also sits outside of the scope of this report), most of which is Government funded.

Although the extended sector contributed about 10% to total R&D spend in New Zealand, it only accounts for about 1% of industry turnover. On a per capita basis that equates to about $5k per firm. What R&D there is, is undertaken by a handful of larger, better resourced firms.

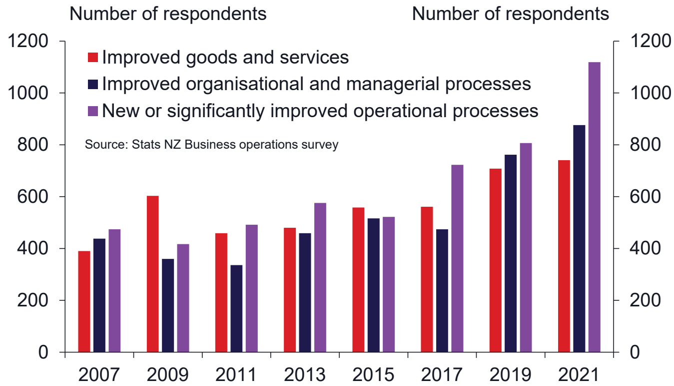
Figure 29: R&D expenditure by the professional services sector



While the level of R&D undertaken in the sector is small, it has trended upwards over time. At their core, professional services firms, like their counterparts elsewhere, hope their R&D investments will yield the critical technology from which they can develop new services. For example, a prominent global accounting firm with offices in New Zealand undertakes ongoing research into accounting methods and new financial/business services. Similarly, a large engineering consulting firm has developed its own proprietary software to support areas of its business.

Increasing R&D spend is reflected in an increase in the number of firms that are introducing innovative practices. Although we think that change is on the way, most professional service providers in New Zealand continue to operate along well-established business lines, which means that innovations tend to be incremental at best. According to Stats NZ data, professional services firms in New Zealand are more likely to innovate their organisational and management processes than operational processes or the services they provide to customers.

Figure 30: Extent of adoption of innovative practices by professional service firms



As in other industries, professional services providers innovate primarily for two reasons. Firstly, innovations help to reduce the costs of delivery as well as provide a point of difference, both of which underpin the ability to compete. Secondly, innovations help to build customer loyalty, principally by increasing the cost of switching between competing professional service providers.

Ultimately, firms realise a return on their investment in R&D from increased revenue or lower costs.

Environmental, social and governance.

Accelerating demand for ESG-related services has been a key growth area for many professional services firms. But to pursue these opportunities, service providers have had to make some changes, not only in terms of the investment they have had to make in their own capabilities, but also in how they approach and tailor their services to ensure alignment with the ESG values upheld by their customers.

Seen as part of their customers' supply chain, professional services firms are increasingly expected to mirror their values and behaviours in their own strategy and practices. To that end, customers are increasingly asking for disclosures from their providers on issues such as governance as well as succession processes to advance the careers of minorities. Some even include financial penalties should professional service providers fall short of their ESG expectations.

Not surprisingly, many professional services firms are taking steps to address these ESG expectations. That includes increasing investment in specific ESG practice areas (often advisory or attestation services), as well as establishing, refining, and articulating their corporate ESG policies and practices. At a more practical level, professional services firms are looking at ways to reduce energy consumption (using more efficient lighting); cut carbon emissions (through less travel and greater use of new communication technologies); improve waste management (through the adoption of circular economy principles such as re-cycle and re-use); as well as introduce greater diversity and equality in the workforce. Success here has been patchy at best.

However, while ESG has created many opportunities for professional services firms, it has also come with risk. For one thing, liability may be created when these firms incorporate ESG offerings into existing as well as new services. That is particularly relevant to audit and tax work. Professional service firms also face scrutiny when reporting on internal ESG issues. Failure to adequately identify, address and report material ESG issues raises the possibility of direct financial impacts as well as negative reputational consequences.

Professional services firms that leverage off their ESG credentials could also find themselves becoming targets of activists. That is especially so if they are found to fall short of their own ESG standards, such as stated carbon emission targets.

Internationally, climate and diversity-related claims and disputes have typically targeted corporations, their directors, and boards. Allegations have related to fraud, misrepresentation, misleading disclosures, breach of fiduciary duties and failure of boards to adequately factor climate change risk into investment decisions. Litigation in these areas has been on the rise, and, although many rulings have been favourable to defendants, the potential liability, including the costs of defending and investigating such claims, is still a significant risk.

An increasing number of professional service providers are taking practical steps to improve their ESG credentials.

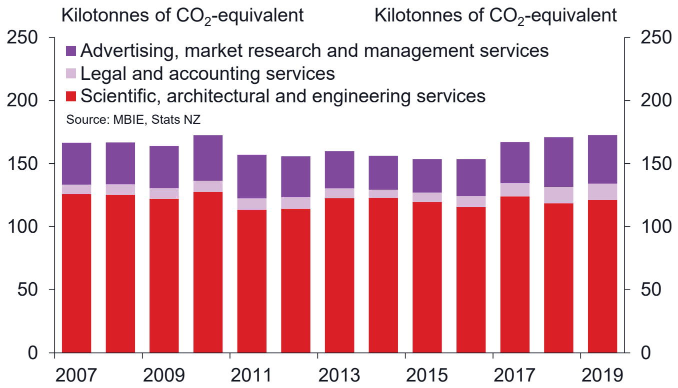
Carbon emissions.

Emissions generated by the professional services sector are small in comparison to those produced elsewhere in the economy. According to MBIE, the sector accounted for 200 kilotonnes of CO_2-equivalent emissions in 2019, contributing about 0.3% to total industry emissions. The sector primarily generates operational emissions from consuming electricity to heat and light offices, the generation of waste, and from business travel.

The professional services industry is a small contributor to carbon emissions.

Despite an increase in activity levels, the professional services sector has been able to keep a lid on emissions, which have largely moved sideways over the past decade or so. Expressed as a percentage of sector value add, emissions have declined steadily over the same period. In large part that reflects an increase in the share of renewable electricity, which makes up 83% of total generation capacity, with the expectation of more to come. It's also likely to reflect an increase in the adoption of emission reduction technologies, such as LED lights, more energy efficient office equipment, electric vehicles, new communication tools, as well as greater opportunities for recycling and reuse.

Figure 31: Carbon emissions produced by the professional service sector



Professional service firms have kept a lid on their emissions despite increased activity.

Further gains are likely with ESG and climate change imperatives now weighing more heavily on purchasing decisions made by customers. Indeed, professional services firms are already tailoring their services and work practices to ensure alignment with customer expectations. That includes the introduction of more flexible working arrangements. These trends are already in train overseas and are starting to emerge in New Zealand.

Fortunately for the sector, most professional services providers are well placed to make these gains. In part that is because they can pass on any additional costs associated with reducing carbon emissions. That reflects three factors: a) the mix and complexity of the services that professional services firms deliver; b) the criticality of those services to customers; and c) size mismatches that occur along the value chain. In the case of the latter, a small number of professional services providers that service a large customer base are likely to have pricing power for a given mix of services. The opposite is also true should there be many providers servicing a relatively small customer base.

As such, the large global behemoths that provide a diverse range of services across many different practice areas are likely to be better placed to pass on the costs of transitioning to a low emissions future than their smaller counterparts who provide a limited range of services. To that end, we think Tier 1 firms are generally better placed to reduce their carbon footprint than Tier 4 firms.

Even if these firms are not able to pass on these costs, most should still have the financial muscle and/or wherewithal to make the organisational changes needed to lower carbon emissions. Changes to work organisation methods are likely to be further advanced by the availability of new digital technologies that help minimise the need to travel and the requirement for office space.

That is true even for the multitude of Tier 4 firms that work from home, where the scope to substantively reduce carbon emissions through changes to work organisation methods is likely to be limited. For many, the decision on whether to make these changes is less likely to reflect their capacity to change, and more on whether they will lead to improved earnings.

Disruptions.

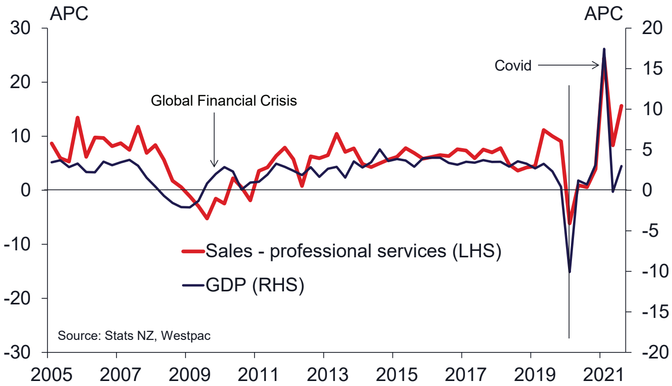
Covid has tested professional services firms and has highlighted many critical weaknesses in how they operate. Specifically, it has made clear the limitations of existing hierarchical business models and their ability to respond quickly to the needs of their customers.

That in turn has accelerated several trends, some of which were already evident before the appearance of Covid. Not least of these has been the increased use of new digital technologies to facilitate the shift towards more flexible collaborative business models that are better able to respond to changing customer requirements. That seems to be backed up by a 2021 global survey by Workforce which revealed that firms that had responded rapidly to the pandemic were much more likely to have embedded agile capabilities such as data accessibility and cross-functional collaboration.

Covid has accelerated digital changes, which are starting to make service providers much more responsive to customer demands.

Despite highlighted weaknesses, most professional services firms have proven to be quite adept at navigating some of the worst aspects of the Covid pandemic.

Figure 32: Professional service sales growth compared to GDP



In part that reflects an ability to respond to changes in the composition of demand. That was most evident early on during the pandemic when customers, facing massive disruptions to their cashflows as well as huge uncertainties about the future, were forced hit the pause" button on many of their discretionary projects, while at the same time shouting loudly for services to help them keep their head above water.

Indeed, this ability to respond to changes in demand was one of the key reasons why the sector was able to outperform the overall economy. Had it not been for the nationwide lockdown on economic activity, it is quite likely that the sector would not have briefly dipped into the red during the early part of the pandemic. To that end, the sector is often referred to as being "recession proof".

However, since the initial shock of Covid, lockdown restrictions have been eased, economic activity has recovered, and customers have returned. Previously shelved projects are now back on the table, and there is a renewed focus on increasing resilience to external shocks and positioning for growth. To that end, a recent survey by the Financial Times in the UK showed that 49% of respondents had increased their appetite for strategy advisory services, while a similar proportion expected to need more help with organisational change and restructuring in the aftermath of the pandemic.

The sector's resilience in the face of Covid also reflects the very nature of professional services firms. As rule, they tend to far less leveraged than their counterparts in other parts of the economy, and typically don't have large amounts of cash tied up in illiquid stock. They also have low working capital requirements. Instead, they rely on the skills, competency, and knowledge of their staff, which they can dial up and down depending on how much work they have in the pipeline. Not only that, but they can also reskill their staff to focus on new practice areas in a short space of time, if that is required.

Professional services firms have positioned themselves to take advantage of opportunities in a post-Covid environment.

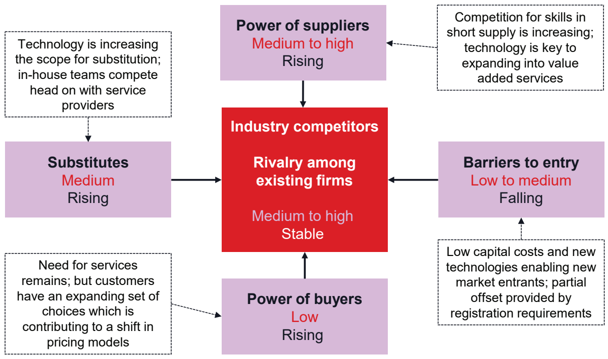
Basis for competition.

Competitive forces are intensifying. Faced with strengthening supplier and rising buyer power, firms are competing harder than ever before. Industry rivalry is further enhanced by low barriers to entry and an increased scope for substitution in some practice areas.

Figure 33 below summarises the magnitude of the competitive forces that are collectively shaping the environment in which professional service firms operate in New Zealand. More specifically, it assesses where a competitive force currently has a 'high', 'medium' or 'low' impact on firms in the sector and whether this impact will be 'rising', 'stable' or 'falling' in the future.

The figure uses a framework developed by Professor Michael E Porter from Harvard Business School. It includes three forces that relate to 'horizontal' competition: the threat of substitutes, which in this case refers primarily to the in-house teams operated by customers, which compete head-on with professional service firms; industry rivalry, which refers to how firms in this sector compete; and the threat posed by new entrants, which refers to barriers to entry into the sector. It also includes two other forces that relate to 'vertical' competition: namely the relative negotiating position of those that supply inputs, principally technology and human capital; as well as the bargaining power of customers in other industries as well as individual households.

Figure 33: Porter's 5-forces model for the professional services sector



Source: Westpac

Threat of substitutes.

Established providers face a growing threat from new digital technologies that are automating an expanding range of services, which can be delivered by non-traditional providers, across a range of delivery platforms. For example, Xero provides cloud-based accounting software, which allows users to automate many tasks that previously would have been undertaken by an accounting services professional. At the same time, advances in data analytics are allowing many firms to undertake service elements that might previously have been outsourced to a professional services firm.

Aligned to these developments is the extent to which downstream firms have their own in-house expertise. That is most prevalent among larger firms where professional services are regarded as core to their business operations. Examples include legal counsel and accounting services departments, which are a common feature of many firms. Similarly, larger corporations and government departments/enterprises often operate their own dedicated strategy teams, which reduce the need for independent management consulting services, while some infrastructure focused businesses employ their own engineering and architectural teams to work on a range of construction projects.

To that extent, the threat of substitutes is relatively high, although that is moderated by the fact that many in-house professional service departments still procure services from external sources in specific practice areas when and where needed. At the same time, technologies such as robotics automation, advanced data analytics and AI are creating new service opportunities for professional services firms. For those that can make the necessary investment, these opportunities are likely to be large enough to offset the impact of the threat of substitutes.

Technology is increasing the scope for substitution within the professional services sector.

Barriers to entry.

Barriers to entry reflect the obstacles or hindrances that make it difficult for new entrants to enter the industry. They include start-up costs, technological challenges, government regulations, and other licensing requirements.

In general, barriers to entry into the professional services sector are low to medium. That is reflected in the high degree of fragmentation that characterises the sector.

Start-up costs are often minimal, with firms requiring little in the way of technology and office space to set up. In fact, many operators in this sector work from a home office. Advances in technology and the pervasiveness of the internet have further reduced barriers to entry. In addition, government regulations tend not to be particularly onerous, and typically apply to all industries.

That's not say there are no barriers. Indeed, most market segments impose strict registration or accreditation requirements at the practitioner level. That is largely to ensure service quality standards are met and the rights of those that purchase services are protected. Academic qualifications, knowledge and expertise are also barriers to entry, but only to the extent that they impact on the ability to meet registration requirements. For example, registered consulting engineers require relevant qualifications. Ditto for lawyers and barristers who must attain valid legal qualifications to gain a licence to practise law.

Regulations can also restrict entry into some practice areas. An industry source, for example, suggested the regulatory penalties for auditing firms that misrepresent the financial circumstances of their customers are so prohibitive that only a handful of large firms are willing to compete in this area.

Entry into some parts of the sector can be quite prohibitive. Indeed, new entrants looking to compete with Tier 1 incumbents face significant hurdles. Not only do they have to invest heavily in building the scale and scope of their operations, but they also must take on well-entrenched incumbents that are able to leverage off strong forward and backward linkages along the value chain, well-established track records and established staff complements.

Another possible barrier to entry relates to the way in which professional services firms cultivate and foster long lasting customer relationships. Indeed, professional services firms typically operate as a 'people-driven business,' where close-knit relationships and personal contacts are regarded as key. Indeed 88% of professional services respondents to a 2020 BoardEx survey indicated that relationship management was critical. Only 10% rated it as important.

Barriers to entry are generally low, although that differs by tiering and the regulatory requirements that apply in each market segment.

Industry rivalry.

Professional services firms mostly compete on price for commoditised services and a combination of price and value for differentiated services. For the most part, billable hours form the basis of price setting in New Zealand.

For those that provide commoditised services, that means minimising the costs of delivery. Technologies that automate processes have a key part to play, but that requires investment, which is likely to be out of the reach of small, cashflow dependent operators focused on the here and now. That even includes lower cost technologies that are provided as a service. Those unable to make the investment required tend to rely heavily on longstanding relationships to maintain market share.

Firms compete within and across market segments, mostly within specific tiers. And to that extent, firms in different tiers complement rather than compete with each other. For example, the 'big four' accounting/management consulting firms in New Zealand, which we designated as Tier 1 firms earlier in this report, tend to service the really large corporates, while Tier 2 firms, which are large firms in their own right, tend to compete more for the business of other larger customers.

A departure from this is the role of small boutique firms that provide highly specialised services to customers of all sizes. To all intents and purposes, they do not compete head on with large players, although they may service the same customers.

That said, for firms that compete head on and attempt to differentiate themselves through value added services, industry rivalry is intense. While price remains important, firms compete more on their capability and capacity to deliver. Considerations include the mix of skills on offer, their competencies, knowledge, and experience in specific practice areas, as well as having the technical capacity to deliver services that customers require.

Industry rivalry within tiers is intense, less so across tiers where firms tend to complement each other.

Power of buyers.

The existence of the professional services sector reflects the extent to which customers value services, which are typically non-core, but nonetheless crucial for their economic, financial, and social well-being. As firms continue to expand, it's likely that demand for professional services will continue to grow. To that extent, the power of buyers is low.

However, there is a difference between services that are required for compliance purposes and those that are of a discretionary nature. For the former, the power of buyers is low - they are mandatory. For the latter, the power of buyers is higher, but only because customers may opt not to procure such services.

At a micro level, customers are still able to choose and switch between individual providers – a key reason perhaps why many service providers place such a strong emphasis on relationship management. Switching costs though differ markedly depending on the nature of services being provided. Typically, they tend to be higher when switching between professional service providers that offer ongoing services, especially if this requires changes to technical supporting infrastructure. Less so for project-based work, where choice comes down to the capacity and capability to deliver.

The power of buyers is also enhanced by the emergence of new substitutes, and the ease with which new entrants can enter the sector. That includes services provided by non-traditional tech-enabled service providers. Both factors can increase supply, which in turn not only raises competition, but also the basis on which services are priced.

As mentioned above, services have been provided on an estimated time (referred to as billable hours) and material basis (plus margin), referred to as input-based pricing. However, in an environment where industry rivalry is strong, barriers to entry are relatively low and new substitutes are increasingly being introduced, customers are not just looking for value-added services but also changes to how they are being priced. That in turn is prompting a shift to outcomes-based pricing, where revenues are tied to the achievement of business outcomes, further adding to the power of buyers.

However, there also some factors that dampen buyer power. The impact of technology looms large in this regard, with buyers continuing to rely on their professional service providers to help them to maximise the benefit from their investments in new digital technologies. In similar vein, buyers are also looking to their service providers to help boost their ESG credentials, which have become increasingly important to their competitive positioning.

Another is the persistent shortage of skilled labour. The mere fact that firms seek professional services is largely a function of capability gaps, and more specifically, a lack of skills. But equally, professional service firms also face significant skills shortages, which limits the choice available to buyers or customers.

The strength of demand for professional services reflects weak buying power, although this is changing as barriers to entry fall and the power of substitutes increases.

Power of suppliers.

As mentioned above, professional services firms rely heavily on their capacity and capability to deliver services required by their customers. That in turn requires access to the right quantity and quality of human capital as well as technology.

Accessing talent has become increasing difficult in recent years, which in turn is increasing the power of suppliers. Among other things that's because the sector, which has always hired the 'best and brightest', faces increased competition from other sectors looking for the same skillsets. The blurring of the lines of distinction between different market segments within the sector will not have helped matters.

Not only that, the skillsets required are also changing. As professional services firms become more customer centric, they are not only seeking out people with strong technical competencies, which will always remain important, but increasingly those with softer skills. EQ is becoming just as important as IQ, and the ability to collaborate and show empathy are becoming increasingly valued.

The impact of technology on supplier power is somewhat mixed. For example, firms that supply new digital technologies that deliver productivity gains and support the delivery of value-added services are likely to exhibit supplier power. How much supplier power depends on how well these technologies are able to deliver these benefits.

But technology can also reduce supplier power, albeit indirectly. Professional services firms are increasingly tapping into tech-enabled marketplaces to access skilled talent, not just within but also across borders, which in turn is helping to dampen the supplier power of labour referred to above.

Despite the moderating influence of technologies, the war for talent suggests that supplier power in this knowledge-based sector is on the rise.

Critical success factors.

Irrespective of what market segment professional services providers operate in, or what size they are, their success depends on understanding where they are positioned in the market and their ability to align their capacity and capability accordingly.

Summary.

Successful professional services firms are clear about the position they occupy on the practice spectrum.

More specifically, they need to be very clear about whether they are "commodity", "procedure" "grey hair" or "rocket science" providers. The most successful professional services firms are focused even where their activities might extend across more than one of these areas. They understand what their customers are looking for, they can articulate their selling proposition, and know how to leverage off their human capital and technology resources to deliver services to their customers.

Firms that are less successful do the opposite. They tend to be spread thinly across many different areas and activities. That in turn dilutes a firm's practice profile and renders it a "jack of all trades and master of none".

Successful firms understand where they sit on the practice spectrum.

Have a clear understanding of market positioning.

Successful firms understand where on the practice spectrum they sit, and they align themselves accordingly. This understanding, which is underpinned by customer expectations, forms the basis for strategic, tactical, and operational decision making for most firms in the sector.

The opposite is true for professional services firms that do not understand where they sit on the practice spectrum. That typically happens when there is a mismatch between how customers view the services offered by a provider and how it views itself.

There are two reasons for this misalignment. Firstly, professionals are prone to overestimating the extent to which their service offering differs from competing services. And secondly, where firms sit on a practice spectrum tends to shift over time. Although a firm might have started out as a "grey hair" solution provider, advances in technology can shift it to being a "commodity" provider relatively quickly, especially if it facilitates imitation by competitors and the internalisation of service elements by customers. An often cited example is Nokia, the mobile phone manufacturer, which was caught napping by advances in technology that gave rise to smart phones.

Successful firms can counter this shift in several ways. For example, they might safeguard distinctive features of their service by limiting knowledge leaks, minimise staff turnover and/or set up technological barriers, such as access controls and knowledge management systems, to protect intellectual property.

But these measures only maintain the status quo. To ensure alignment with increasing customer expectations, firms must continually innovate and introduce new service offerings, while giving up those that have been commoditised. As the New Zealand experience shows, neither is easy to do. While innovation creates new solutions, it also destroys the existing order. That might increase demand for some skillsets, but it also reduces it for others, threatening the livelihood of those affected.

Giving up solutions that have become commoditised can be challenging. Indeed, there is often a reluctance to cut services even when margins come under pressure, especially if they are still generating revenues. That in turn reflects a tendency in the sector to obsess over revenues rather than profits, which in turn fosters an "any business is good business" mentality. That may explain why many accounting firms continue to sell traditional accounting services, despite losing market share to the likes of Xero. This line of reasoning, however, disregards the fact that once a firm is seen as a commoditised solution provider, it's extremely difficult for it to move back towards the premium end of the spectrum, and the long-term reputational damage can be significant.

Put the customer at the heart of the business.

Once firms have a clear understanding of where they sit on the practice spectrum, they need to identify which customers they intend to service. Typically, that is done by leveraging off readily available customer data and using data analytics tools to segment customers into groups. The objective of this exercise is to provide a focus for marketing and sales strategy/tactics, with a view to improving profitability. According to a study by Bain & Company, firms that have great segmentation strategies enjoyed a 10% higher profit than those whose didn't.

Increasingly professional services firms are being judged less on the services that they provide and more on how they help customers get to where they want to be. Indeed, customer success is becoming the new measure which professional services providers are using to assess their own performance. That is a departure from the past when success was largely based on delivering customer service excellence, which is more about managing projects, mitigating risk, and responding to cost escalations. And there is good reason for that. Research by Deloitte in 2017, for example, showed that customer-centric firms are about 60% more profitable than those that are not. Similarly, HubSpot's annual survey of the state of service in 2022, found that an increase in customer retention of just 5% can equate to a 25% increase in profit.

Redefining success for professional services providers starts with redefining what success means for the customer.

For professional services firms, the challenge is to offer services that deliver customer success in a way that does not require additional resources. Indeed, that is likely to be one of the reasons why many providers continue to hold back, even though there are numerous automation tools that can help put the customer at the heart of the business, without the need for additional resources.

Successful firms achieve this in three ways. Firstly, they look to break down traditional silos in their organisation (see below), empowering sales experts to efficiently engage project/service professionals as content contributors. Secondly, they limit time-consuming tasks that take the focus away from the customer. That includes using tools like knowledge management that facilitate the efficient sharing of knowledge and information. And thirdly, they engage with customers on a frequent and repeated basis to show, amongst other things, that customer feedback counts as well as to ensure that they can change course if needed. In that regard, building and maintaining close-knit relationships and personal contacts is key to ensuring a firm's prosperity.

Increase organisational agility.

A key characteristic of professional services firms is their ability to pivot quickly to changing circumstances. In large part that reflects the reliance that they place on human capital, which can be dialled up or down depending on the nature of demand conditions. Should these conditions change dramatically, professional services firms also have the option of reskilling.

This ability to dial up or down human capital will continue to be critical to their success. But by itself that is not a guarantee of organisational agility.

Organisational agility is a much broader concept that focuses on how well firms are set up to respond to changes in their external environment. These changes may be demand-led, such as disruptions caused by Covid, or may reflect actions taken by competitors which affect supply, such as the introduction of a new service. Increasingly, changes in the external environment are being led by ever-more demanding customers wanting more choice, more convenience, more value, and more control.

Agility is important. According to McKinsey, agile organisations are 70% more likely to appear in the top quartile of organisational health – a strong indicator of future success. Agile professional services firms tend to be more customer-centric, take products from concept to market more quickly, have higher revenue growth, lower costs, and a more engaged workforce. Being agile also helps to avoid overpromising and underdelivering.

Achieving organisational agility depends on two key factors:

The first is ease of access to the factors of production. The ability to attract the right skills is critical, especially in an environment where competition for talent is intensifying and the requirement for skills is expanding well beyond technical competencies. The ability to tap into talent marketplaces is likely to increase in importance as a result.

Successful firms also need to be able to navigate the accelerating pace of digitisation as well as the impact of disruptive technologies. About a third of respondents to a 2021 global survey by Workday agreed that the adoption of digital technologies helped to improve organisational resilience, especially in the face of a crisis. As such, investment in new digital technologies is a must, but that doesn't mean that firms need deep pockets, although that helps. Indeed, many professional service providers opt to outsource their technology requirements by purchasing information, platform capabilities and software as a service (IAAS, PAAS, and SAAS, respectively) rather than incurring the costs of developing in-house proprietary systems.

The second is how to use these factors of production to deliver the services that customers want. Again, digital technologies loom large, helping firms to move from traditional hierarchical operating models where teams work in silos towards network models where flexible, scalable, multi-disciplinary teams take on end-to-end accountability for service delivery. That in turn promotes empowerment, collaboration, and entrepreneurship. Indeed, teams that can quickly find and collaborate with others that have relevant knowledge are typically more creative and innovative, and this leads to improved value for the customer. In this regard, accuracy of advice is critical.

Knowledge sharing and cross-departmental collaboration helps firms to adapt quickly to changing customer requirements.

Contact the Westpac economics team

Michael Gordon, Acting Chief Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Nathan Penny, Senior Agri Economist
+64 9 348 9114

Paul Clark, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

Disclaimer

Things you should know

Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141 ('Westpac').

Disclaimer

This material contains general commentary, and market colour. The material does not constitute investment advice. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. This material may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Country disclosures

Australia: Westpac holds an Australian Financial Services Licence (No. 233714). This material is provided to you solely for your own use and in your capacity as a wholesale client of Westpac.

New Zealand: In New Zealand, Westpac Institutional Bank refers to the brand under which products and services are provided by either Westpac or Westpac New Zealand Limited ("WNZL"). Any product or service made available by WNZL does not represent an offer from Westpac or any of its subsidiaries (other than WNZL). Neither Westpac nor its other subsidiaries guarantee or otherwise support the performance of WNZL in respect of any such product. The current disclosure statements for the New Zealand branch of Westpac and WNZL can be obtained at the internet address www.westpac.co.nz. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement.

China, Hong Kong, Singapore and India: This material has been prepared and issued for distribution in Singapore to institutional investors, accredited investors and expert investors (as defined in the applicable Singapore laws and regulations) only. Recipients in Singapore of this material should contact Westpac Singapore Branch in respect of any matters arising from, or in connection with, this material. Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activities. This material is intended only to "professional investors" as defined in the Securities and Futures Ordinance and any rules made under that Ordinance. Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking and Insurance Regulatory Commission (CBIRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

UK: The contents of this communication, which have been prepared by and are the sole responsibility of Westpac Banking Corporation London and Westpac Europe Limited. Westpac (a) has its principal place of business in the United Kingdom at Camomile Court, 23 Camomile Street, London EC3A 7LL, and is registered at Cardiff in the UK (as Branch No. BR00106), and (b) authorised and regulated by the Australian Prudential Regulation Authority in Australia. Westpac is authorised in the United Kingdom by the Prudential Regulation Authority. Westpac is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

This communication is being made only to and is directed at (a) persons who have professional experience in matters relating to investments who fall within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this communication or any of its contents. The investments to which this communication relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this communication or any of its contents. In the same way, the information contained in this communication is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Conduct Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on the information in this communication to any third party. In particular this communication and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. This communication is made in compliance with the Market Abuse Regulation (Regulation(EU) 596/2014).

Investment recommendations disclosure

The material may contain investment recommendations, including information recommending an investment strategy. Reasonable steps have been taken to ensure that the material is presented in a clear, accurate and objective manner. Investment Recommendations for Financial Instruments covered by MAR are made in compliance with Article 20 MAR. Westpac does not apply MAR Investment Recommendation requirements to Spot Foreign Exchange which is out of scope for MAR.

Unless otherwise indicated, there are no planned updates to this Investment Recommendation at the time of publication. Westpac has no obligation to update, modify or amend this Investment Recommendation or to notify the recipients of this Investment Recommendation should any information, including opinion, forecast or estimate set out in this Investment Recommendation change or subsequently become inaccurate.

Westpac will from time to time dispose of and acquire financial instruments of companies covered in this Investment Recommendation as principal and act as a market maker or liquidity provider in such financial instruments.

Westpac does not have any proprietary positions in equity shares of issuers that are the subject of an investment recommendation.

Westpac may have provided investment banking services to the issuer in the course of the past 12 months.

Westpac does not permit any issuer to see or comment on any investment recommendation prior to its completion and distribution.

Individuals who produce investment recommendations are not permitted to undertake any transactions in any financial instruments or derivatives in relation to the issuers covered by the investment recommendations they produce.

Westpac has implemented policies and procedures, which are designed to ensure conflicts of interests are managed consistently and appropriately, and to treat clients fairly.

The following arrangements have been adopted for the avoidance and prevention of conflicts in interests associated with the provision of investment recommendations.

(i) Chinese Wall/Cell arrangements;
(ii) physical separation of various Business/Support Units;
(iii) and well defined wall/cell crossing procedures;
(iv) a "need to know" policy;
(v) documented and well defined procedures for dealing with conflicts of interest;
(vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

U.S: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission ("CFTC") as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC ('WCM'), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 ('the Exchange Act') and member of the Financial Industry Regulatory Authority ('FINRA'). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. All disclaimers set out with respect to Westpac apply equally to WCM. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.