



## 2016 Client Advisory

“It is not the most intellectual of the species that survives; it is not the strongest that survives; but the species that survives is the one that is best able to adapt and adjust to the changing environment in which it finds itself.”

– **Leon C. Megginson, Professor of Management and Marketing at Louisiana State University at Baton Rouge (in a 1963 speech on Charles Darwin’s ‘The Origin of Species’)**<sup>1</sup>

<sup>1</sup>1963 June, Southwestern Social Science Quarterly, Volume 44, Number 1, *Lessons from Europe for American Business* by Leon C. Megginson, (Presidential address delivered at the Southwestern Social Science Association convention in San Antonio, Texas, April 12, 1963), Start Page 3, Quote Page 4, Published jointly by The Southwestern Social Science Association and the University of Texas Press

# Executive Summary

The legal industry has been largely characterized by more modest revenue and profit growth rates in the past few years, in stark contrast to the pre-2008 period. In addition, dispersion in performance among law firms and year-over-year volatility in performance for individual firms has increased. These market dynamics are likely to continue.

While the demand for traditional law firm services has remained relatively soft, the supply of legal service providers has increased, creating a hyper-competitive<sup>2</sup> market, and forcing law firms to rethink how they deliver legal services. The firms that outperform the rest of the industry will likely be those that successfully pursue dual strategies of growth and operational efficiency, while at all times staying attuned to the changing needs of their clients and broader target market. Firms also recognize that they will need to adapt their culture to respond to client demands and to retain key talent.

We expect overall industry revenue and profitability<sup>3</sup> growth rates in both 2015 and 2016 to be in line with the low single-digit growth rates of 2010 - 13, with continued dispersion and volatility.<sup>4</sup>

<sup>2</sup>Source: Citi 2015 Law Firm Leaders Survey – response from the managing partner of an Am Law 100 law firm

<sup>3</sup>Profitability can be defined in any number of ways, including net income, net income margin, profit per partner and contribution per lawyer (revenue per lawyer minus expense per lawyer). While no one metric captures the entire story of a firm's profitability, for purposes of this Advisory we are generally referring to either profit (net income), or profits per equity partner (PPEP)

<sup>4</sup>Our analyses and projections are based on data collected from a sampling of primarily US-based law firms by Citi Private Bank and Peer Monitor, as well as conversations with law firm leaders. For firms headquartered outside the US and third-party providers of legal services, our information is mostly anecdotal. Sources include, the "Citi Annual Survey Database" of 201 U.S. headquartered firms, including 41 Am Law 1-50 firms, 37 Am Law 51-100 firms, 51 Am Law 2nd 100 firms, and 72 additional firms; the "Citi Flash Survey"; including 42 Am Law 1-50 firms, 40 Am Law 51-100 firms, 42 Am Law 2nd 100 firms and 54 additional firms; the "2015 Law Firm Leaders Survey" of 67 large firms; and "Thomson Reuters Peer Monitor" data of 143 U.S.-based law firms, including 48 Am Law 100 firms, 42 Am Law 2nd 100 firms, and 53 additional firms

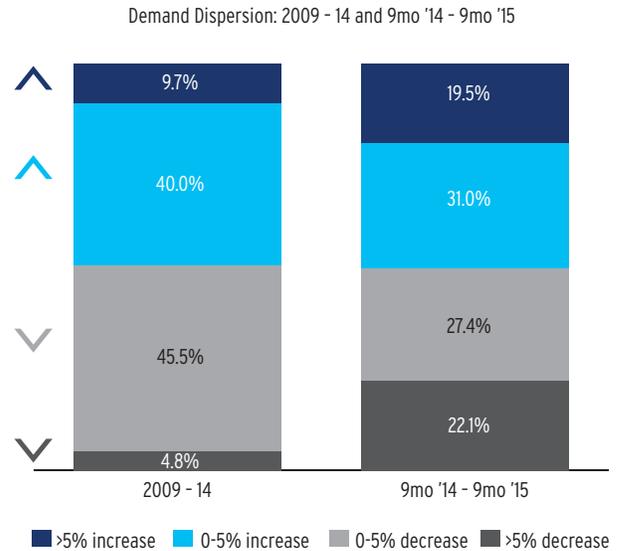
# The Post-Recession Demand and Profit Environment

After annual profit growth rates of roughly 10% from 2001 to 2007 and then the severe downturn and dislocation that occurred in 2008 and 2009, average growth rates from 2010 to 2013 were in the low single-digits. Although low single-digit growth seems mild compared to the highs and lows of 2001 - 09, it's actually similar to typical growth rates seen before that period. From that perspective, 2001 - 07 and 2008 - 09 were both aberrational periods. In hindsight, 2014 is also now looking aberrational with its relatively higher growth rates, especially since 2015 appears to be on track to finish with similar growth rates to those seen during 2010 - 2013 (unless there's an unusually large surge in fourth quarter collections).

Behind the post-recession industry averages, we have seen dispersion in demand performance (a key driver behind revenue performance) of firms across the industry. Chart A shows that approximately half of the firms reporting to us showed an increase vs. a decline in demand from 2009 to 2014. This has continued through the first nine months of 2015. The fact that demand has increased for some firms means that there is work to be had. In a hypercompetitive market, it suggests that these firms have managed to differentiate their brands from others, a topic we will look at more closely later in this Advisory.

We've also seen increased volatility in the demand results of firms from one year to the next. A firm that sees demand growth one year could very well report a decline the next, and vice-versa. In Chart B, we see increased year-over-year volatility in recent years. Indeed, some law firm leaders have told us that they are framing annual results in the context of the firm's performance over at least a two-year period. Keeping a healthy perspective is particularly necessary in a volatile market.

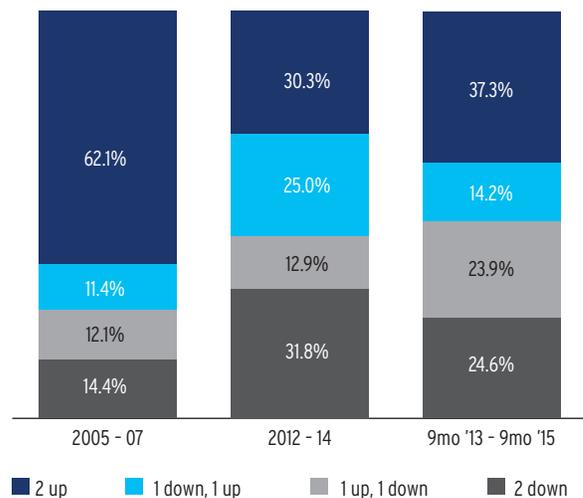
## Chart A: Demand Dispersion



Source: Citi Annual Survey Database: 2009 - 14; Citi Flash Survey: 9mo '15

## Chart B: Demand Volatility

Demand Volatility: 2005 - 07 vs. 2012 - 14 vs. 9mo '13 - 9mo '15



Source: Citi Annual Survey Database: 2005 - 14; Citi Flash Survey: 9mo '13 and 9mo '15

Dispersion and volatility are also evident in the industry's profitability performance in recent years, as depicted in charts C and D. Firms can generally deal with short-term volatility in profitability, most notably PPEP, if partner expectations are managed. However, for firms that have seen declining PPEP over a longer period of time, or a widening gap to other firms, there is a risk that high-performing partners start to move to stronger-performing firms. Beyond being a prime target for lateral hiring, a firm may become a full-fledged acquisition candidate, or risk dissolution.

The media has tended to focus on the widening dispersion between the highest PPEP firms and everyone else. It is not realistic to set elite firm profitability as the yardstick by which other firms are measured. Consequently, while charts E and F<sup>5</sup> show this form of dispersion has indeed increased, this is not what concerns us the most. Charts E and F show a widening dispersion between firms whose profitability levels were fairly closely aligned in 2009. This form of dispersion will likely have a profound effect on the legal industry in the years ahead and lead to further consolidation.

Chart C: PPEP Dispersion

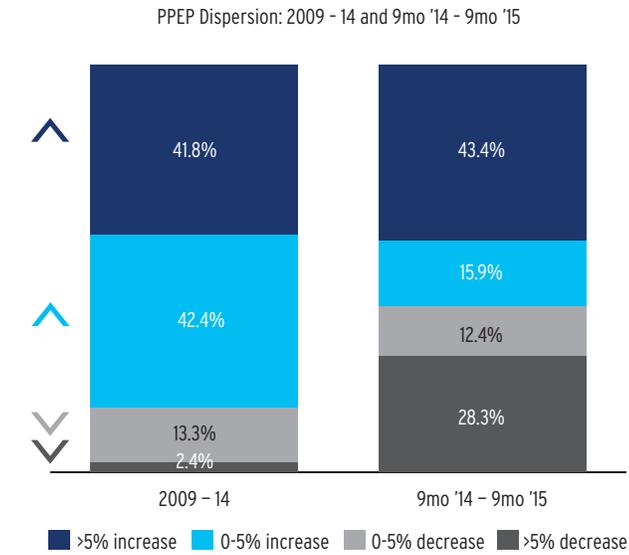


Chart E: Dispersion Between Quartiles

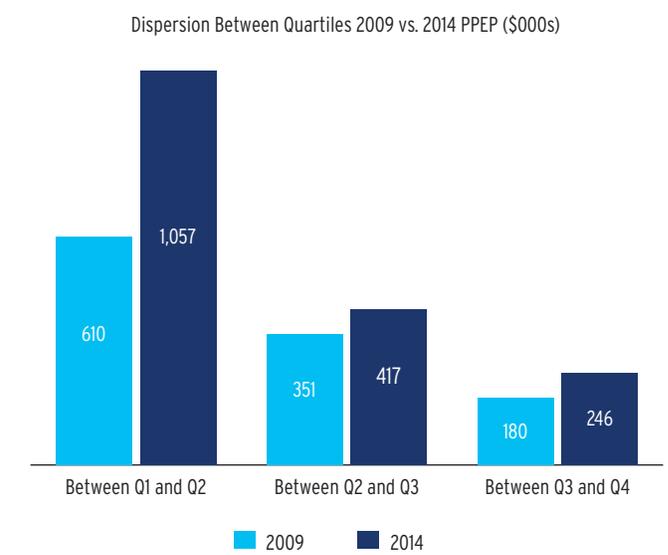


Chart D: PPEP Volatility

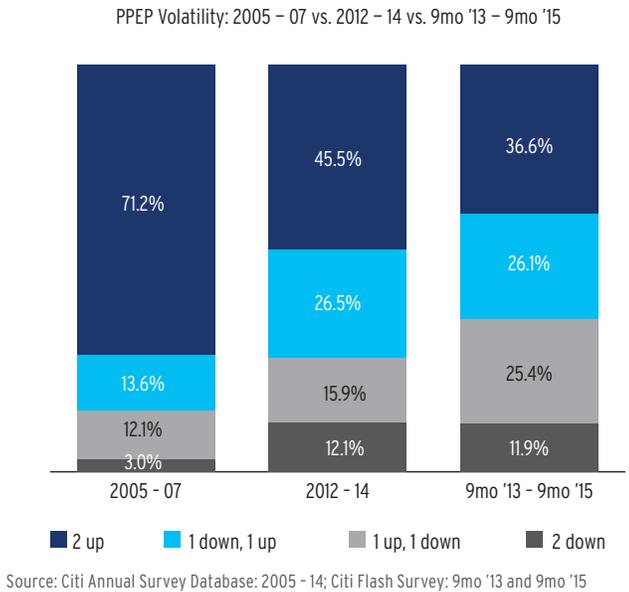
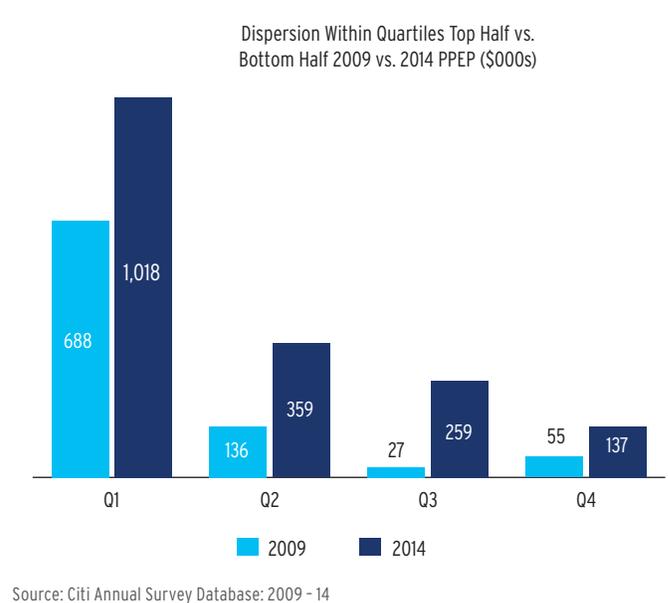


Chart F: Dispersion Within Quartiles



<sup>5</sup>For this analysis, 163 common firms were ranked in both 2009 and 2014, using a profitability composite of 4 metrics (profits per equity partner, profits per all partner, contribution per lawyer and net income margin). The firms were then broken into quartiles of roughly 40 firms for each of the two years. Chart E shows changes in PPEP dispersion *between* quartiles from 2009 to 2014, while chart F shows changes in PPEP dispersion *within* quartiles (between the top performing half and the bottom performing half of each quartile)

# 2015: Good, But Not 2014

The overall financial performance so far this year in the legal industry is indicative of where the industry appears to be moving. As noted earlier, based on nine-month results, the legal industry is on track to experience full-year 2015 PPEP growth more in line with 2010 - 2013 CAGRs<sup>6</sup> and short of the level achieved in 2014. Yet, behind the averages, we continue to see dispersion across different segments, as well as volatility for individual firms. While interim data is not necessarily an indication of full-year results, the 9mo'15 data included in charts A and C indicate that we could see an increase in the percentage of firms with a greater than 5% drop.

Revenue growth gained momentum as the year progressed, but it has not kept pace with 2014, while expense growth has been greater than last year. The primary drivers of revenue through the first nine months of 2015, while solid, were all weaker than last year – demand growth lagged, effective rate increases were lower, and the collection cycle lengthened slightly. It should be noted that the revenue growth at the global and international firms in our sample has been adversely impacted by significant volatility in foreign exchange rates.

We expected year-over-year demand growth would be more difficult to achieve in the second half of 2015 than in the first half, on account of the pickup in demand during the second half of last year. Demand growth did in fact slow in the third quarter. Through six months, demand was up 0.9%, the same as through the first half of last year. But demand growth through nine months didn't keep pace, up only 0.6% vs. 1.6% during the same period last year.

The primary driver behind expense growth was lawyer compensation increases, resulting from a 1.0% increase in lawyer headcount and higher bonuses. At the time of writing, early indications suggest that year-end bonuses will be flat to 2014, relieving some of the pressure on expenses. The headcount increase reflects not only new hires during the first nine months of this year, but also hires during the fourth quarter of last year when demand was increasing. A shift toward a more senior demographic would also have put upward pressure on compensation.

This increase in lawyer headcount also exceeded the growth in lawyer demand, so lawyer productivity declined 0.5%. This compares to an improvement in productivity of 1.0% through

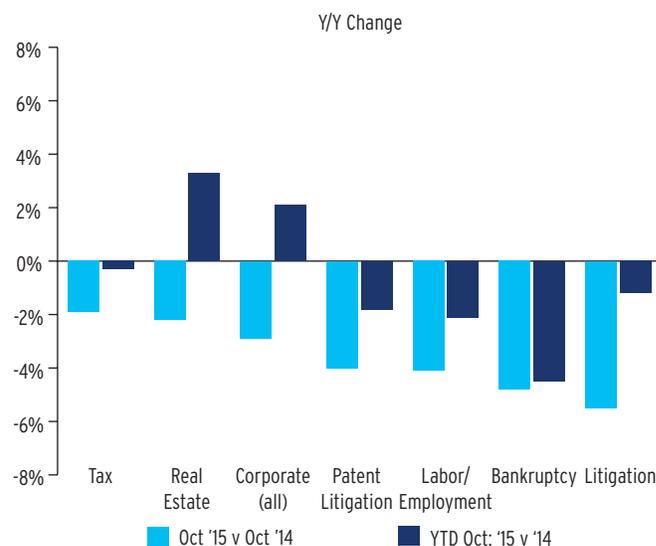
the same period last year. If demand isn't robust in the fourth quarter, then lawyer productivity is likely to remain down. We therefore won't see any reduction in the continuing excess capacity in the industry, which exacerbates pricing pressure.

Although law firms increased overall lawyer headcount, they continued to manage equity partner headcount more closely, which was up only 0.4%.

Looking at the results by revenue size, the Am Law 51-100 outpaced the other Am Law segments in revenue, demand and billing rate growth. Smaller/niche firms also had strong revenue growth. However, this result was driven by a small number of strong performers and benefited from a relatively low hurdle because of weak 9mo'14 results.

Growth by practice area is summarized in Chart G. Through the first ten months of 2015, real estate and corporate are the only practice areas to have experienced year-over-year demand growth. Consistent with what we've seen over the past couple of years, litigation remains soft.

Chart G: Demand Growth by Practice Area



All timekeepers  
 Billable time type; non-contingent matters  
 Oct '15 had one fewer working day than Oct '14  
 Source: Thomson Reuters Peer Monitor

<sup>6</sup>Compound Annual Growth Rate

# 2016 and Beyond

## 2016 Financial Projections

We expect 2016 performance will be consistent with 2010-2013 performance levels. With more modest demand and inventory growth anticipated by the end of 2015 compared to the end of 2014, however, 2016 likely will start off with revenue growth challenges. Most of the growth will continue to come from transactional activity rather than litigation, while firms with a global footprint will likely continue to benefit from the opportunities presented by an increasingly global market.

On the expense side, we expect to see continued focus on improving efficiency. We anticipate that the primary areas of focus will remain improving matter management, rethinking leverage and staffing models, and managing down occupancy costs. While these efforts should ultimately help temper expense growth, most won't happen overnight, and some will likely increase expenses in the near term. In particular, we expect to see continued investments in technology as firms improve their management systems, and as they secure their systems against cybersecurity risks. There could also likely be upward pressure on health care and compensation expense associated with the increases in lawyer headcount that occurred this year.

We believe that low single-digit growth in industry revenue and profitability is now typical. Behind the averages, there will also be continued dispersion and volatility in performance, with some firms lagging more than others and causing further consolidation.

With respect to firm balance sheets, we expect that the majority of firms will continue raising partner capital requirements, while limiting borrowings at the firm level, consistent with the more conservative capitalization strategies we've observed since the Great Recession.

## Key Market Characteristics

The market in 2016 and beyond is likely to be characterized by the following themes:

### An Increasingly Global Legal Services Market

Large law firms continue to grow their global platforms. As a result, the global legal market is becoming extremely competitive and, in some markets, over-crowded. The most successful global firms will be those where the goal is to service clients with global needs and to diversify the firm's practice profile. Given the cost of investing in new offices

around the world, we anticipate some office closures and withdrawal from specific markets, just as we've seen in the last two years. Being in international locations should be based on either the fact that the firm has clients that want their firm in global locations, or that the firm has a significant global clientele in its home location and finds it important to protect their domestic client base. That said, cross-border activity is growing and having international locations, which may not be as profitable as traditional locations, may just be an essential cost of doing business for some.

US firms have been reporting strong activity in their London offices. Citi Private Bank Annual Survey data shows a 21% increase in hours worked in US firms' London offices from 2012 to 2014.<sup>7</sup> It's important to note, however, that despite the strong performance for these firms as a group, there are still many US firms with unclear UK strategies. The more US firms do well in London on their own, the less incentive they have to merge with local firms. On the other hand, UK firms entering the US have been met with a relatively more saturated market, which has made them more likely to look to the lateral market for growth opportunities.

In mainland Europe, business has picked up in Germany, but not so much in Spain and Italy. Meanwhile, Russia continues to be very challenging, due largely to oil prices. While activity in the Middle East is also heavily reliant on oil, demand levels appear to be stronger in this region, particularly in Dubai. On the other hand, the recent slowdown in energy markets has adversely impacted demand levels in Canada.

China remains a challenging market for foreign firms, although they remain optimistic about the future. There is speculation that China may be considering changing restrictions on foreign firms doing business there. Although we have heard of no specific proposals, it is true that Shanghai is now allowing foreign firms to align with a Chinese firm if they are located in a free trade zone. Chinese firms, for their part, are making their platforms more global, so that they can service Chinese companies on outbound investments. Given recent combinations between Chinese firms and western firms, we anticipate that additional Chinese firms will be examining their options.

Singapore continues to be a destination for global and regional law firms. It is attractive for a number of reasons. The Singapore government welcomes foreign law firms and has made it one of the best countries in Asia in which to conduct business. The country has one of the busiest ports in

<sup>7</sup>Source: Citi Annual Survey Database: 2012 - 14

the world. It has been an international arbitration center for almost 25 years, and more recently has become a commodity trading center. Many firms have also made the decision to use Singapore as a base for serving their Indian practices.

Australia has seen rapid consolidation over the last few years, but we expect that will slow. The Australian economy is reliant on resources, and current market conditions may reduce interest in foreign firms opening offices there.

Africa is drawing interest from more foreign firms, and there have already been some mergers and joint ventures with global firms. We believe this interest will continue.

Latin America is a region worth watching. There has already been consolidation in Mexico through acquisitions of local firms by US firms. This interest is the result of the Mexican government allowing more foreign investment in the country. Several global firms have entered the Latin American market, despite some restricted practice rules in Brazil. There has also been some limited consolidation among Latin American firms. Political change in a few countries may be the driving force behind future developments in the legal profession. We predict that more global firms will enter the Latin American market in the years ahead.

Notwithstanding global expansion, we think there will be continued consolidation in the US. Expansion will likely occur where there are growth industries. Washington, D.C. continues to be one of the most important domestic markets. Despite the disruption caused by the drop in the price of oil, some firms see this as an opportune time to invest in Texas. Meanwhile, New York and California remain popular.

## A Changing Supply and Demand Equation

As we wrote in our last Client Advisory, we are operating in a buyer's market, having witnessed notable growth in the range of law firm service providers available to clients. In an effort to grow through geographic expansion, law firms have entered new markets, competing with incumbent firms. We've seen the growth of lower-cost alternatives to traditional law firms that use technology and lower-cost staffing models to handle routine, lower-value work at the right price point for clients. We have also seen accounting firms in markets outside of the US increasingly compete with traditional law firms.

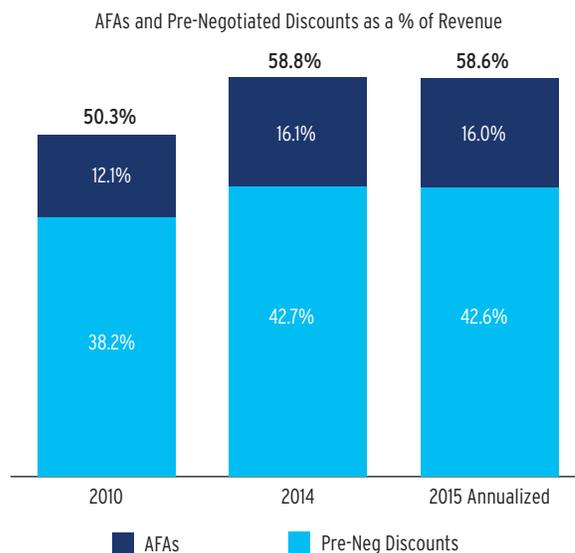
Law departments will look for the most efficient provider of services, based on value. While this is not a new concept, the current demand/supply equation has given them the buying power to better realize their goal of getting greater value for their legal spend. More will be sent to lower-cost service providers. While the focus to date of these efforts has been on relatively routine commodity work, we expect that over time, lower-cost service providers will find ways to broaden the scope of work they can handle. Certainly, technology developments will enable more work to be done at a lower cost by a range of service providers. Although improvements

in technology in general might appear to threaten law firm business, they also present opportunities to improve efficiency, which will be addressed later in this Advisory.

More work will also be kept in-house in an effort to control costs. Some believe this is a fundamental shift, while others note that we're in a cycle that will end, and that in the past, law departments have bulked up, then scaled back when the costs of running a larger law department became too great. This latter view suggests that in time we will see a shift back to more work being sent externally, whether to traditional law firms or to lower-cost service providers. In the interim, however, less work will come to law firms. In time, if the cost of running the law department becomes too great, we may see companies sending out more work to traditional law firms (as well as to lower-cost service providers) than we see in the current market, especially to those firms that will offer more attractive pricing.

In this flat-to-modest growth environment, the combination of increased competition from traditional law firms, the emergence of lower-cost service providers, and more work being done in-house is driving pressure on law firm pricing. We see this in the form of alternative fee arrangements and pre-negotiated discounts to billing rates. It should be noted that the use of AFAs has not increased at the rate many observers had predicted, although according to the Citi 2015 Law Firm Leaders Survey, a majority are still expecting growth in the years ahead. Furthermore, while there are firms that derive a substantial percentage of their revenue from AFAs, our data shows that, on average, pre-negotiated discounts are more predominant (see Chart H). Whether the pricing pressure comes from pre-negotiated discounts or AFAs, the desire to protect profit margins has been a motivating force for improving operational efficiency.

### Chart H: AFAs and Discounted Rates



Source: Citi 2015 Law Firm Leaders Survey

Client demands for more efficient delivery of legal services, and pressure on margins, have already caused firms to think differently about how they deliver legal services, and we anticipate more of this. Firms have begun to focus more on understanding the cost of running matters, for budgeting purposes, and they are utilizing project management in an effort to manage costs and maintain margins. AFAs, in particular, require tight budgets, as well as frequent client communication. Firms are also reexamining the leverage model, and using more lower-cost lawyers where appropriate. In becoming more focused than ever before on operational efficiency, they are looking more closely at matter, client and practice profitability.

While clients will want to see more value for money, they will continue to pay more for what they perceive as high value. The challenge for law firms is to differentiate their brand from others, and to demonstrate that the value they bring to clients justifies their fees. The higher the value, the greater the demand and revenue growth opportunities will be for firms.

### Growth Opportunities at the Practice and Industry Level

As noted earlier in Chart G, firms are continuing to see greater strength in transactional practices than in litigation practices. Global M&A continues to be strong, driven by the top end of the market. Although the total number of announced deals is below 2007 peak levels, the number of \$10B+ deals is the most on record. Firms with cross-border capability and strong transactional practices will benefit disproportionately from the growth in mega deals, while other firms will be negatively impacted by any further reduction in overall volume.

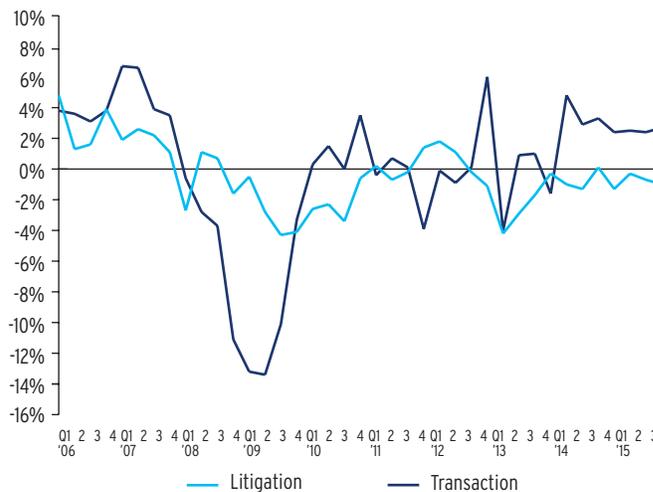
By dollar volume, Health Care, Technology and Financials have seen the most significant jump since 2014, and in fact made up 50% of US M&A volume. Cross-border activity is also up over last year, especially for transatlantic deals, perhaps a sign of more to come. While the drivers of M&A – CEO and Board of Director confidence in the economy, lots of cash, and cheap credit – remain fairly strong, a potential risk to future deals is historically high valuations. Another is that in the third quarter of 2015, not all acquirers saw the jump in stock price that other acquirers had recently enjoyed after announcing acquisitions. If this becomes a trend, given that stock is usually used as a part of payment, confidence may erode, making deals more difficult.

Besides M&A, law firm leaders see opportunity in certain other practice areas. Cybersecurity and data privacy will likely continue to be strong growth areas, as clients react to the increased risks and responsibilities attendant to managing personal information. Firms have highlighted growth in their Health Care and Pharmaceutical practices, although we have been told that some areas are quite price-sensitive.

### Softening Demand for Litigation

Over the past few years, given the growing cost of large scale litigation, the appetite of law firm clients to litigate all the way to trial has waned, reducing the demand for litigation services, as depicted in Chart I.

Chart I: Demand Growth – Litigation vs. Transactional Practices (All Segments)



All timekeepers billable  
Source: Thomson Reuters Peer Monitor

Law firm litigation practices have been disproportionately impacted by the trend in disaggregation of work, either doing more work in-house, or sending relatively routine work to low-cost providers, rather than to traditional law firms. While low-cost providers are growing, they still represent a small segment of the legal market.

This has caused a more extreme version of the demand/supply imbalance described earlier, resulting in strong pricing pressure, as clients with budget constraints favor firms that aggressively discount their services.

Improvements in technology have also disproportionately impacted litigation practices more than non-litigation practices by reducing the number of hours spent on a client matter. Either lawyers are leveraging technology to finish their work in fewer hours, or they are losing the business to third-party providers.

Although these trends are expected to continue, not all litigation practices have fared equally. During the post-recession years, for example, financial industry litigation and bankruptcy work were strong, although there's a concern now that both are in runoff mode. Intellectual Property litigation has generally been strong, especially for trademark matters, although the nature of patent litigation has been undergoing a change. With increased global business, we expect to see an increase in demand and complexity of cross-border regulatory work, international investigations, cybersecurity and risk management issues.

We are also watching the increased interest in litigation funders. The type of financing they provide, which is complementary to bank funding, might encourage some general counsel to pursue litigation, although sufficient setbacks in the courtroom could curb their appetite to finance cases. This funding might also encourage firms that don't wish to assume 100% of the risk of contingency litigation to pursue high stakes litigation. If either or both of these dynamics gain traction, it would bode well for litigation demand.

### Cybersecurity Risks

As we'll discuss in a later section, helping clients handle cybersecurity-related issues has been a growth area for law firms. However, law firms are facing the same risks that many of their clients are susceptible to. While mitigating these risks has been an area of focus for some time now, it has added a layer of complexity to running a law firm that is unlikely to disappear and will increase expenses in the years to come.

### A Changing Market for Talent

The aggressiveness of the lateral market and increasing dispersion in profits are increasing the risk that firms might lose top partner talent. Having a solid culture helps reduce the risk, but so does communicating with these partners frequently and managing PPEP expectations, especially if the firm is experiencing volatility.

Firms are also challenged by the pipeline of new partner talent. Either the lure of other industries, or the desire not to "grow up to be like the partners," often results in greater turnover among associates than firms like to see. In addition, the pool of potential associates seems to be either shrinking, or is less qualified than in the past. According to data available through the Law School Admissions Council, enrollment at US law schools in the US dropped 17.6% from 2011 to 2014.<sup>8</sup> The quality of the law school product could also very well be diminishing: in September 2015, Bloomberg cited data received from the National Conference of Bar Examiners, indicating that scores from the multiple-choice portion of the July 2015 bar exam reached their lowest level since 1988.<sup>9</sup> There's also the concern that those law school graduates who do excel are opting not to pursue careers with a traditional law firm. Given the trends coming out of US law schools, a reasonable question to ask is whether the legal industry is heading for a talent crisis, which of course would increase salaries. It should be noted that the issues outlined in this paragraph pertain mostly to the US.

Related to these concerns about obtaining and retaining key talent are concerns over the aging of the partnership and succession planning, not only at the firm level, but also at the practice group level, especially in light of turnover risk.

## How Firms Will Successfully Address Market Opportunities

### Focusing On Revenue Growth

In this hypercompetitive market, revenue growth will come from a combination of building a differentiated brand, investing more in business development efforts, and getting closer to clients. It will also continue to come from lateral hiring, mergers and acquisitions.

### Brand Differentiation

Successful law firm leaders recognize that in a hypercompetitive market, where price has become the main differentiating factor, brand differentiation is of utmost importance. Indeed, when we look at the most profitable firms in the Citi Annual Survey, we note that they all have built strong brands. We've observed that in differentiating themselves, these firms have built a brand in one or more practice areas or industries, while maintaining practice areas that make strategic sense for supporting brand name practices.

We've observed firms building brands on an industry focus. Where firms have undergone significant change, we see them rebranding themselves to ensure the market understands their current capabilities. We see other firms differentiating their brands by emphasizing their robust and geographically extensive platforms. They do this to attract clients, as well as laterals. These firms believe that they will be best placed to support clients in the increasing amount of cross-border work.

We've also observed an increased focus on business development and marketing efforts to become a "go to" firm. Marketing professionals have told us that while some partners are natural "business developers," others struggle. We envisage that the more successful firms will continue to invest in helping partners develop their business development skills.

We have noted the recent growth in spending on marketing and business development. According to Citi Private Bank Annual Survey data, from 2012 to 2014, compensation expense for marketing personnel increased 18%, and general (non-compensation) marketing expenses increased 17%.<sup>10</sup> We anticipate that firms will continue to evaluate the impact of marketing and business development initiatives on revenue growth, from the size of dedicated teams, to the skill sets of partners.

<sup>8</sup>Source: [www.lsac.org/lisacresources/data](http://www.lsac.org/lisacresources/data) "All Term Applicants, Admitted Applicants & Matriculants to ABA-Approved Law Schools by Country of Citizenship"

<sup>9</sup>Source: [www.bloomberg.com/news/articles/2015-09-17/bar-exam-scores-drop-to-their-lowest-point-in-decades](http://www.bloomberg.com/news/articles/2015-09-17/bar-exam-scores-drop-to-their-lowest-point-in-decades)

<sup>10</sup>Source: Citi Annual Survey Database: 2012 - 14

### **An Increased Focus on the Client**

Law firms have long known that their existing clients represent a potential source of additional demand and revenue. As hours have become increasingly difficult to come by, many firms have focused more on developing their client teams to better understand their clients' needs and identify opportunities to handle their work for their clients across a broader range of practices and offices. One managing partner recently told us his firm saw a 30% increase in business from clients served by client teams.

Successful law firms will continue to focus on mining existing relationships for additional business. Beyond asking clients what they think about the firm's performance on the last matter, and why they use other service providers for work currently not coming to the firm, law firms will focus on understanding how the performance of the client is measured, and what its goals and objectives are. Firms will seek to understand what the pain points are for their clients. An increased focus on understanding the client will enable firms to tailor their services to truly meet the needs of clients. With talk of innovation in the industry, in this hypercompetitive market, it's surely what clients would regard as innovation that counts.

### **Growth Through Lateral Hiring, Mergers and Acquisitions**

As a means of achieving "instant" revenue growth, lateral hiring remains much more likely than a merger or acquisition, particularly among larger firms. Law firms are aggressively pursuing laterals in targeted geographic or practice areas, either to fill gaps or provide deeper bench strength. In fact, we are increasingly seeing "lateral lift outs" of larger groups of lawyers.

While there have been some recent merger discussions among larger firms, acquiring a relatively smaller firm has been more prevalent. Altman Weil has reported that there have been 68 announced combinations through the end of the third quarter of 2015. Of those announced deals, there were only three in which the smaller firm had more than 125 firms.<sup>11</sup>

Over the past several years, we've observed some mergers that have been based on well thought out business plans. We are concerned, however, with firms that follow a growth for growth's sake approach to their business. These firms will face difficult integration issues regardless of the partnership structure they utilize. Time will provide the answer to whether these firms have the business plan and client acceptance to match their growth aspirations.

### **Improving Efficiency**

As client demands for greater efficiency from their law firms increase and pricing pressure continues to squeeze margins, successful law firms will become more focused than

they already are on operational efficiency. This will involve examining new ways to manage profitability at the matter level, greater focus on the leverage and staffing model, and more creative use of space.

### **Matter Management**

In order to maintain their margins, successful law firms will become even more focused on understanding the scope, and therefore the cost, of a matter. As we've reported in past Client Advisories, an increasing number of law firms are making greater use of project managers, who are tasked with helping partners determine necessary resources, stay on budget and avoid scope creep. We expect to see greater use of project managers, as well as pricing specialists, to help partners understand the true cost of running a matter before they agree to an alternative fee.

### **Knowledge Management and Artificial Intelligence**

We expect to see more focus on knowledge management. We've noted that some firms have pulled back on knowledge management efforts, in response to clients' data security concerns. It's our view that firms can address clients' concerns about data protection, while continuing to build systems and processes to share their collective know how, to the benefit of their lawyers and ultimately their clients.

While there is talk of the increasing use of artificial intelligence in law firms, it's too soon to tell exactly what its impact will be.

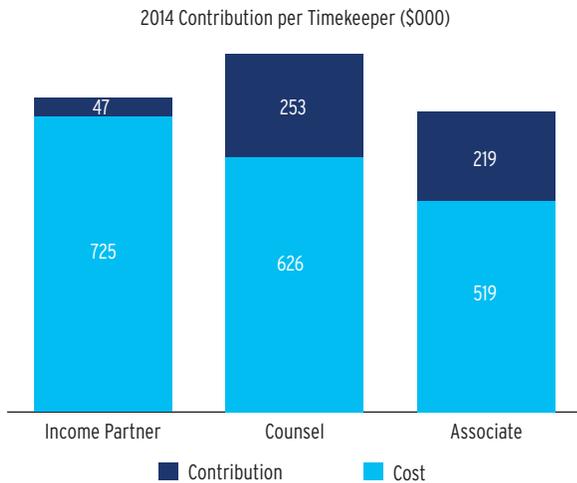
### **Rethinking the Leverage and Staffing Model**

Because of client pressure to improve efficiency and reduce the cost of legal services, law firms are taking a closer look at the mix of who's doing the work. While mindful of the need to keep costs down, they also recognize the need to bring the required skill set to a particular matter.

We've reported in past Advisories about the shift that has been taking place over time in firm leverage models, as firms have moved to fewer associates and more senior lawyers, such as counsel and income partners. Even the associate population itself has become more senior. There have been several factors at work here, including historically small associate classes, the lengthening of the partnership track, the tendency to hire laterals as income rather than equity partners, and reclassifications from equity partner. As the leverage model has become more senior, however, it has also become more expensive. And at many firms, the most senior lawyers in the leverage model, namely income partners, are not contributing as much as associates. In some cases, they don't generate sufficient revenue to cover their compensation and pro-rata share of overhead. Chart J shows that in 2014 income partners on average contributed less to net income than either counsel or associates.

<sup>11</sup>Source: Altman Weil MergerLine for the first nine months of 2015

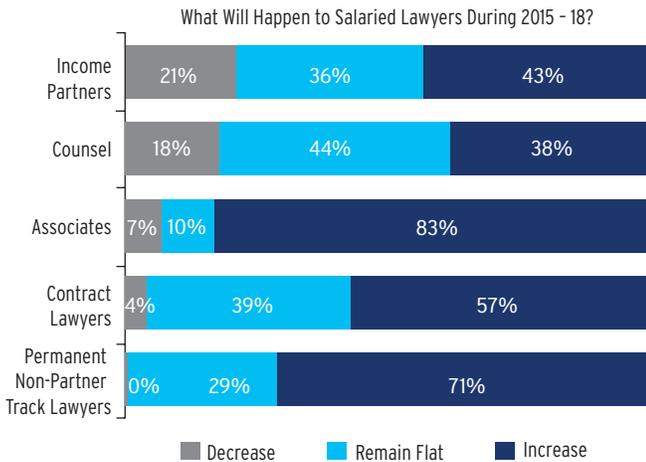
## Chart J: Contribution Levels



Source: Citi Annual Survey Database: 2014

According to the Citi 2015 Law Firm Leaders Survey (see Chart K), over the next few years, perhaps in response to increasingly expensive leverage, law firms are anticipating a shift, with a minority of firms expecting to see an increase in income partners, and the majority anticipating an increase in associates. The majority of firms are also planning to increase the use of less expensive non-partner track lawyers. They are also planning to rely more on contract lawyers, which would enable firms to effectively shift a fixed cost to a variable cost, one that can be ramped up and scaled back as needed.

## Chart K: Anticipated Shift in Leverage Mix 2015 – 18



Source: Citi 2015 Law Firm Leaders Survey.

One interpretation of these projected changes is that, going forward, some of the work that has historically been done by income partners will be done by counsel and senior associates, while some of the work that has traditionally been done by junior associates will be done by non-partner track and contract lawyers. Such changes would have the benefit of reducing the overall cost of leverage.

<sup>12</sup>Source: Citi Annual Survey Database: 2007 and 2014

We also expect to see continued close scrutiny of the staff to lawyer ratio, which has already dropped from 1.06 in 2007, to 0.90 in 2014.<sup>12</sup> While we've witnessed firms investing more in higher quality finance, human resources, information technology, and marketing and business development resources, we have also seen an overall reduction in other staff, most notably legal secretaries. Where it makes economic sense, firms are also making the decision to outsource rather than keep permanent staff.

In response to the pressure on pricing, we are seeing an increasing number of large, global firms create centralized global operations centers to help manage costs. Small and mid-sized firms don't have the same advantage of scale and will be challenged to find similar ways to reduce costs.

### Efficient Use of Space

We are aware that firms are focused on being more efficient in the use of office space and reducing their footprint where it makes sense. Some have managed to reduce their square footage per lawyer over the past few years, and we know many others have the same goal. We have heard of some creative ideas beyond simply reducing office size, or doubling up within existing offices. One idea is to eliminate offices altogether and place lawyers at workstations to improve collaboration. Another is to issue tablets and cell phones, rather than desktop computers, which makes lawyers more mobile and less in need of permanent office space. These ideas are reportedly popular among Millennials, for whom technology and the ability to collaborate are particularly important. Since occupancy is the largest expense after staff, we expect creative designs will continue to emerge, as we have seen in recent office refurbishments.

### Adapting The Firm's Culture

Leaders of successful law firms recognize the need and challenge of adapting their firm cultures to the changes in the market. For most firms, this begins with getting partners to leave the status quo behind and focus on the need to adapt to changes in the industry. This includes acceptance of a flat demand environment and the need to become more of a business developer. It means making greater use of technology and possibly a new leverage model. It also means understanding and accepting the likelihood of PPEP volatility.

Law firm leaders will need to continue to pay attention to shifting demographics at their firms. The growing proportion of Millennials, in particular, will affect how firms approach recruitment, training and communication. It will also impact the infrastructure that firms build, including how they set up offices, and make use of technology and social media. This increase in Millennials can also present opportunities to law firm leaders, not only in their knowledge of technology and social media, for example, but also perhaps by bringing a fresh perspective to how firms deliver their legal services to clients.

# Conclusion

The legal profession in our opinion is the most over-analyzed of the professional service professions. Much of what is being written today about large law firms has been written before, and much of what has been forecasted in the past has not been accurate. This has underestimated the capabilities and leadership in place at large firms around the world, which we believe is far better than some want the public to believe. Despite the challenges that law firms have been facing in this post-Great Recession environment – soft demand, greater client expectations, increased competition – and the pronouncements of some doomsayers, we believe most firms are making the changes necessary to deal with what will likely be the new reality for the foreseeable future. And while the return of double-digit growth rates for the legal industry is unlikely, there's a lot to be said for steady, if unspectacular, low single-digit growth rates, especially if softness in demand continues.

While there is no question about the changes occurring in the delivery of legal services and the challenges facing all firms, our advice to leaders is not to lose sight of the most

pressing issues of the day. The search for future revenue, greater operational efficiency, competitive profitability and talent retention will be key. Even as they seek new sources of revenue, the most successful firms will stay close to their clients, anticipating any change in their needs and always looking for ways to deliver additional value.

As always, we stand ready to assist our clients in meeting the challenges of today's markets.

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