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2021 Report on the State of the Midsize Legal Market:

A surprisingly strong year to build upon

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Executive Summary

To say that 2020 was an unprecedented year is a tremendous understatement.

Law firms had to deal with sudden, jarring dislocations to their practices, as well as to their clients and the overall economy. Seemingly in an instant, everything changed — how and where work is done, interaction with clients, client needs, along with factors affecting the personal side of work-life balance.

Managing through that change has uncovered both challenges and opportunities. Clearly, 2020 was an exercise in responding swiftly and decisively to massive disruptions. And 2021 may allow for a strategic reassessment of what works — or no longer works — in this new environment.

One of the most significant changes was the shift to working from home. The transition has major implications going forward for firm overhead costs, productivity, delivery of legal services, and technology investments.

While changes such as these have been dramatic, they can also mean opportunity. This may be especially pertinent for the midsize law firm segment[1], which has advantages that may enable it to uniquely capitalize on a rapidly changing market.

The 2021 State of the Legal Market,[2] produced in collaboration with the Georgetown Center on Ethics and the Legal Profession, stated that most law firms anticipate a return to something resembling pre-pandemic levels by the second or third quarter of 2021.

But the legal market that emerges may behave differently than the one that existed previously.

A look at midsize law firm performance — By the numbers

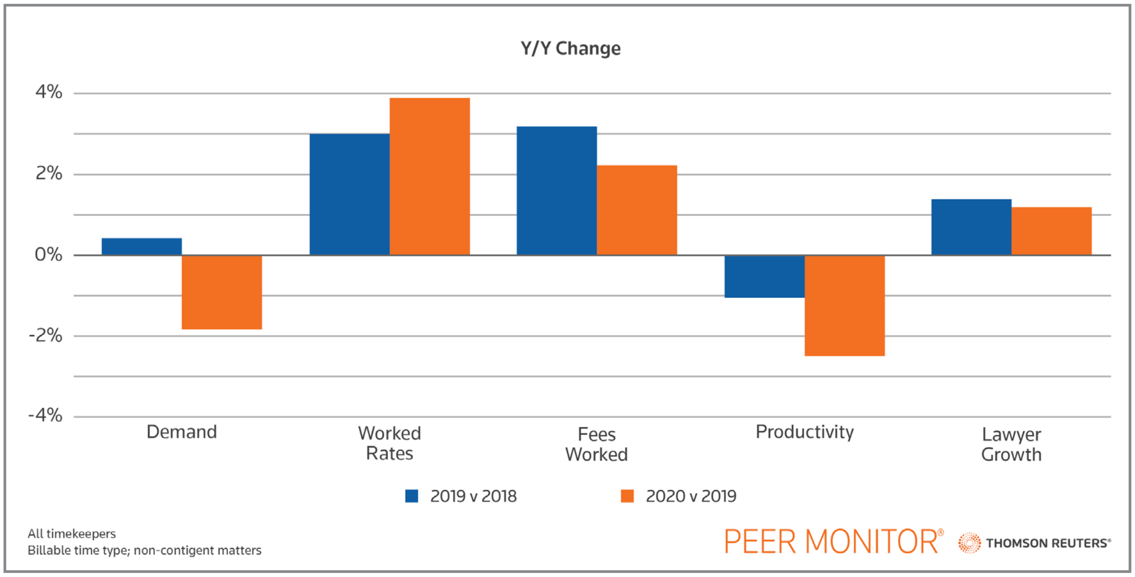
Midsize firms emerged from 2020 somewhat shaken and bruised, but surprisingly resilient. Firms made a series of major moves to reconfigure their operations and bolster firm profitability. They ended the year with some positive developments despite the many disruptions.

While demand was clearly down from previous years, the year ended with an upwards trend. Most notably, the midsize market segment saw strong profitability. Profits-per-equity partner grew by 5.8% in 2020, nearly double the growth rate of 2019.

At the same time, and despite these encouraging developments, midsize firms struggled in many ways to keep up with their larger competitors.

However, as we move deeper into 2021, rapidly changing market dynamics could bring new opportunities that midsize firms might be uniquely positioned to capitalize on.

Figure 1 – Key Performance Measures

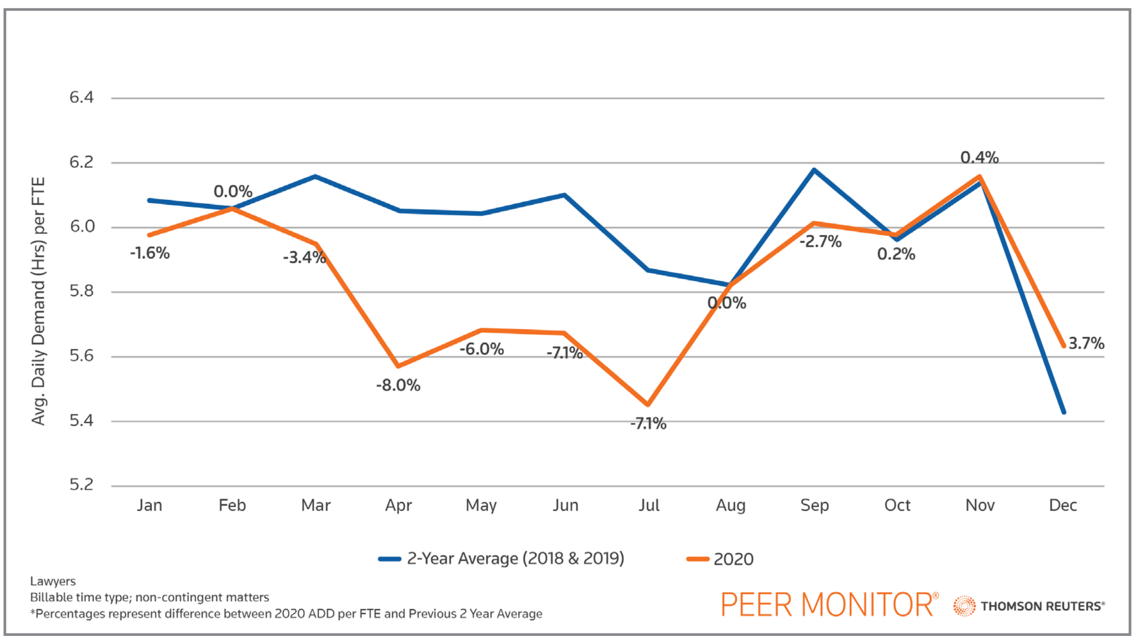


But first, a look back at how 2020 played out will help set the stage for the evolving challenges and opportunities that lie ahead. While the onset of the global COVID-19 pandemic early in the year clearly had a sudden, dramatic impact on nearly all law firms, the year as a whole was in some respects a play in three acts.

In act one, the year started strongly for midsize firms, building on the strength of 2019. But as the pandemic took hold in act two, demand plunged, driven downwards by the antagonistic effects of reduced demand for corporate work and litigation as businesses shifted their priorities and courthouses closed.

Following that sharp initial drop, act three saw demand for midsize legal services begin a slow, steady recovery in the second half of the year.

Figure 2 – Average Daily Demand Per FTE



At the end of the year, when the calendar turned, demand had finished down 1.9%. While a significant drop, it was not nearly as severe as some had feared in the early stages of the pandemic.

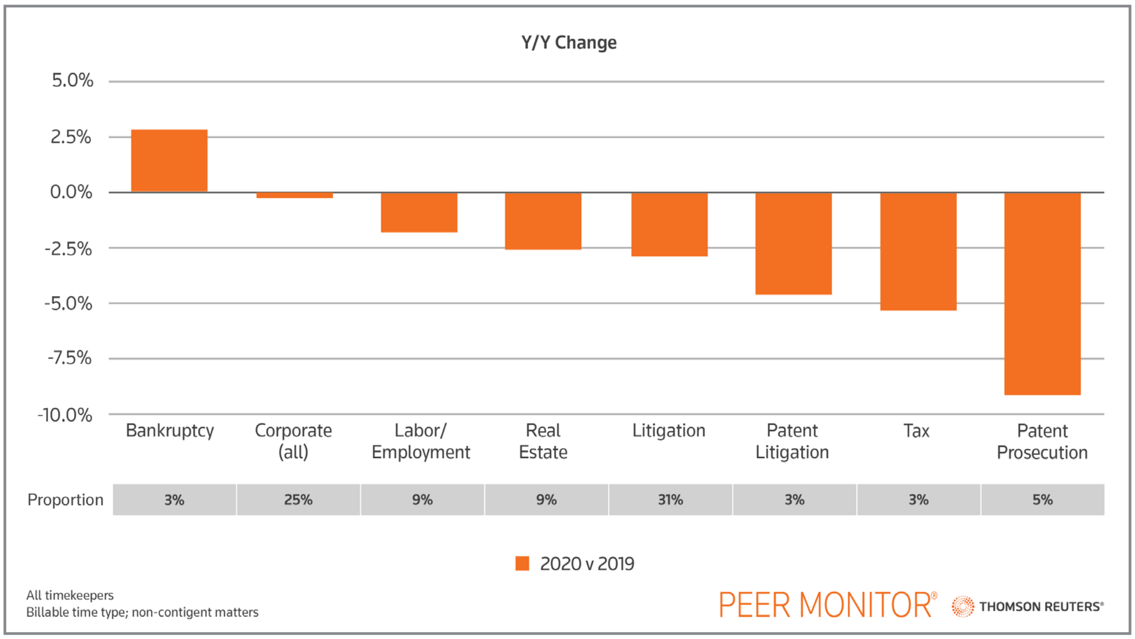
Practices

Breaking down demand by practices, it's not surprising that most major practices declined for midsize firms. In particular, litigation — which typically makes up about one-third of billings — was down 2.9% due to courthouse closings and restrictions when courts did reopen.

While corporate work initially slumped as the pandemic took hold, it recovered towards the end of the year. Bookended by a strong start to the year, corporate work managed to finish 2020 nearly flat, down only 0.2% — a remarkable achievement under the circumstances.

The high point for practice demand was bankruptcy, which surged 2.8% during 2020. But all other major practices, such as labor and employment, real estate, IP, and tax, finished down for the year.

Figure 3 – Demand Growth by Practice



Rates[4]

Higher rates helped midsize firms offset the lower demand. For the previous three years (2017-2019) and even into early 2020, midsize worked rate growth had been locked into a fairly consistent range, between 2.5% and 3.3%. This was occurring even while other market segments were accelerating their rate growth.

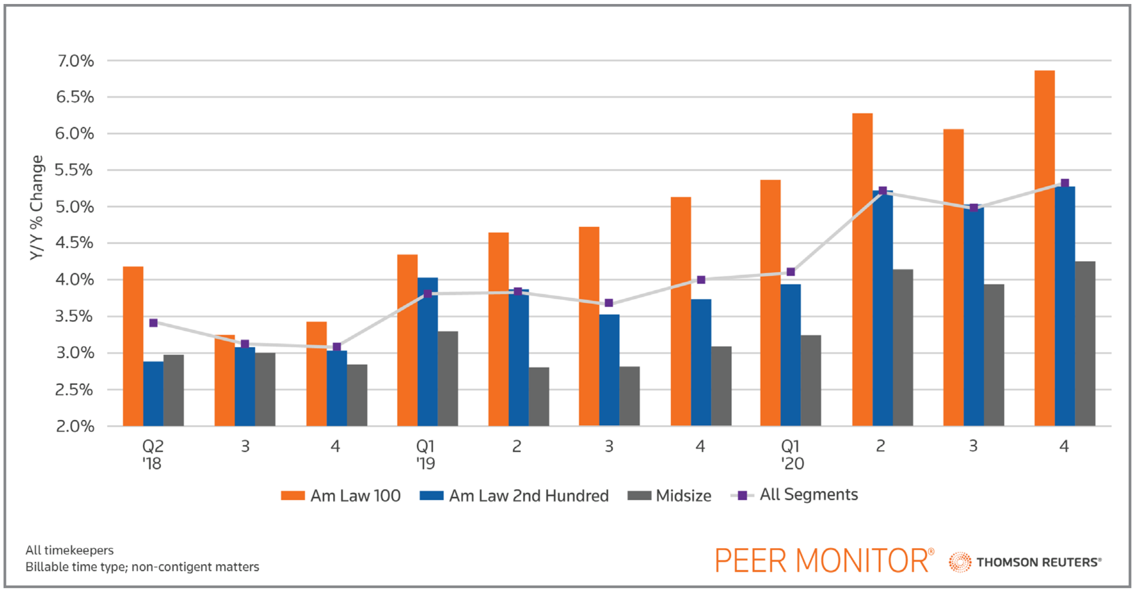
Then in the last nine months of 2020, midsize rates jumped sharply, rising at their highest pace in more than a decade.

Significantly, even though midsize rates climbed at a near-record pace, their pricing gap compared with larger firms actually increased, as larger firms grew their rates at an even faster pace.

For example, in 2017 and 2018, Am Law 100 rate growth was about one percentage point higher than midsize firms, and slightly higher than that in 2019. And as rates shot up across the board in 2020, that gap widened significantly. Am Law 100 firms were now increasing their rates a full 2.2 percentage points faster than midsize firms. Midsize rates grew a strong 3.9%. But Am Law 100 rates jumped by an average of an eye-popping 6.1%.

While that differential is likely to fall back more towards historical norms, it opens the door for midsize firms to emphasize their favorable cost-value proposition.

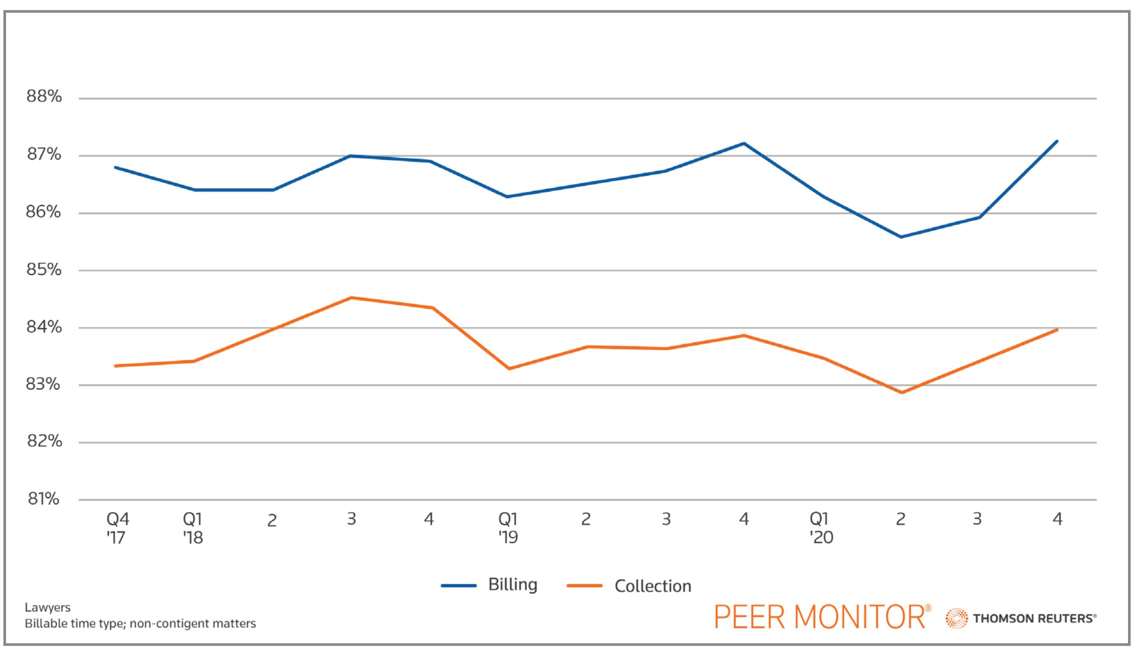
Figure 4 – Worked Rate Growth



For all of the segments, 2020's jump in average worked rates was due more to allocation of work rather than the rates themselves, as an increasing proportion of work shifted to the partner level. In the midst of the pandemic crisis, clients often turned to more senior partners for counsel, relying on trusted, long-standing relationships for guidance through the crisis. In addition, many firms reduced their headcount for associates, of counsel, and non-lawyer timekeepers, further impacting the shifting proportion of hours that contribute to the calculation of average worked rates.

Midsize firms were also diligent about realization as the year progressed. They significantly improved both billings and collections, reversing a short slide in Q1, and staving off concerns of precipitous declines in both metrics. The combination of higher average worked rates and improved realization helped partially offset revenue declines resulting from reduced demand.

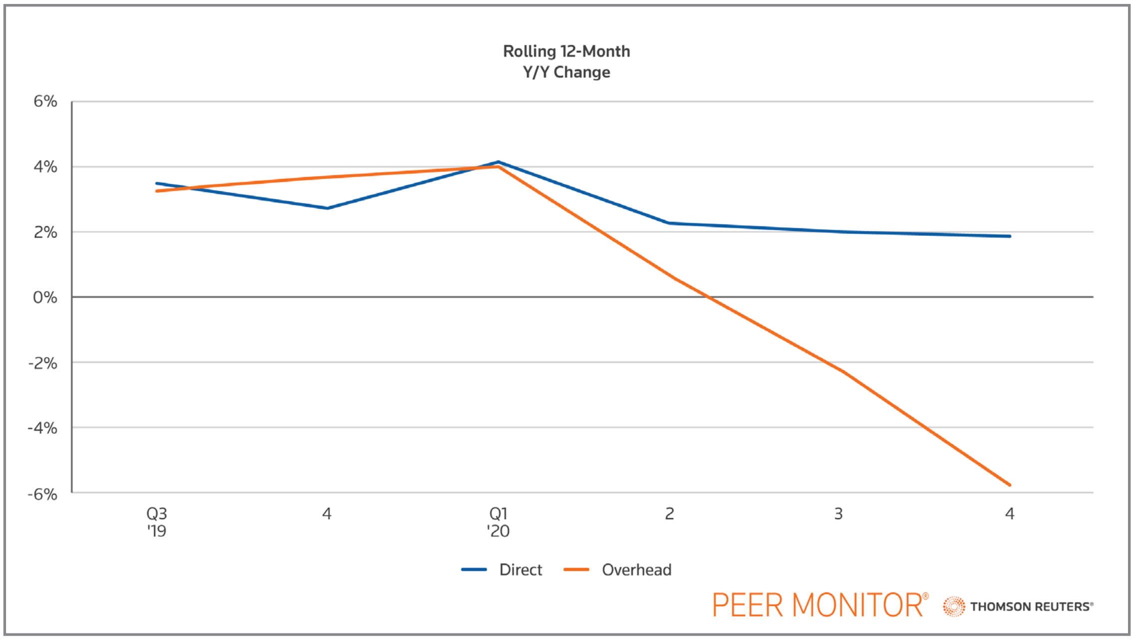
Figure 5 – Realization Against Standard Rates



Expenses and investment

As it became apparent in early 2020 that demand was likely to suffer, midsize firms moved quickly to cut expenses.

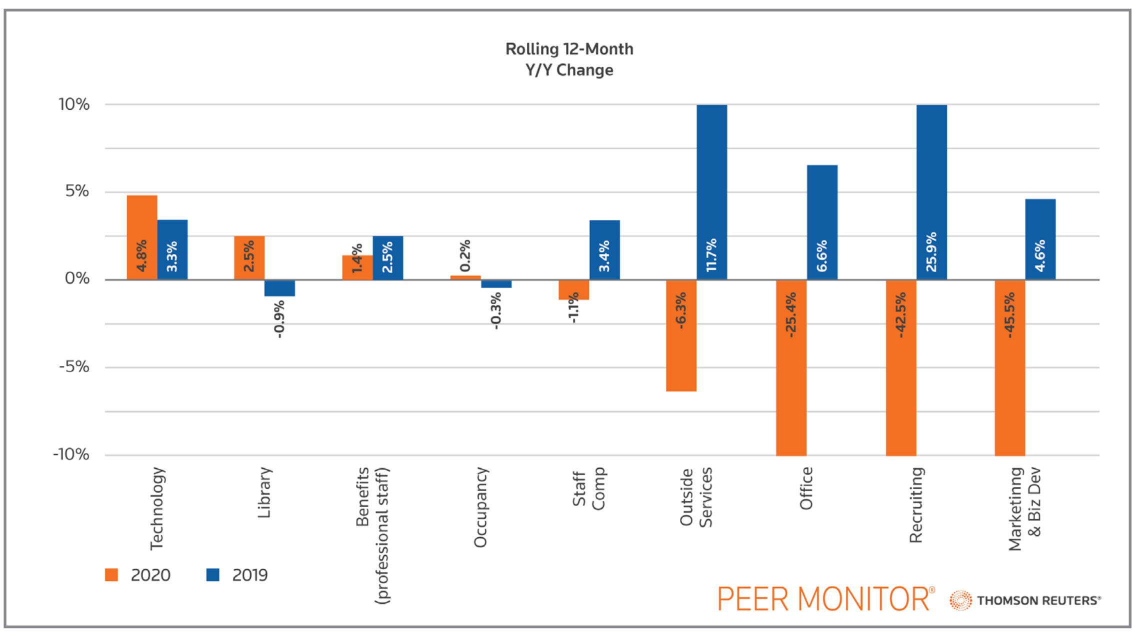
Figure 6 – Expense Growth[5]



While firms held direct expenses in check through slight reductions in associates, of counsel, and non-lawyer timekeepers, even greater reductions were realized in overhead expenses.

These overhead expenses contracted for the first time since the financial crisis of 2008-09. In particular, the move to work from home contributed immediate and major cost savings. Office expenses, which make up about 8% of overhead, fell by 25%. Business development and marketing, and recruiting, were slashed by more than 40%. These reductions, as well as other cost savings, such as travel, contributed to the strong profitability growth even in the face of declining demand.

Figure 7 – Overhead Expenses Detail



At the same time, firms continued to strategically make investments to position themselves for both near-term and longer-term success.

Firms increased their investments in technology, and said they plan to do so again in 2021. Technology spend increased 4.8% in 2020, up from 3.3% in 2019. Much of that increase was necessitated by remote working needs as firms scrambled to maintain continuity of workflow with a suddenly remote workforce.

However, the investments in technology are expected to continue or even accelerate this year. The 2020 Law Firm Business Leaders Report from the Thomson Reuters® Institute found that half of firms surveyed plan to increase their use of technology to cut costs.[6]

In 2020, much of the law firms' technology investment was devoted to remote work infrastructure — laptops, cloud-based technologies, web conferencing, VPNs, and other connectivity, etc. With remote infrastructures now largely completed, firms are turning their attention to technologies that can bolster workflow productivity in other ways. The Law Firm Business Leaders Report found that technologies such as legal project management, financial management information systems, platform and collaboration tools, document automation, and matter management analytics are among the biggest targets for adoption and upgrades.

Firms are also keeping an eye on the future and continuing to invest in advanced technologies such as artificial intelligence, blockchain, and smart contracts to further improve efficiency.

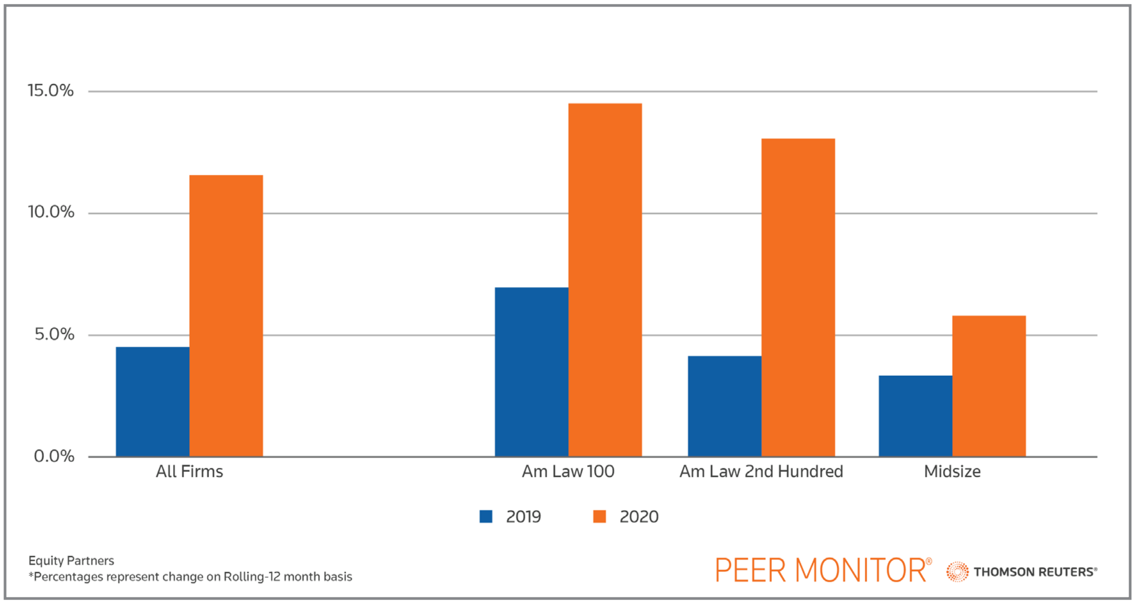
Strong profitability but performance gaps

While midsize firms saw many positives coming into 2021, at the same time, they struggled at times to keep up with their larger competitors.

In 2020, midsize law firms trailed larger firms across all major metrics – demand, revenues, profit growth, and productivity. While midsize firms saw multi-year highs for rate growth and profitability, larger firms saw even higher growth.

Profitability for midsize firms shot up as a result of the higher rates and cost reductions, which more than offset the drop in demand. Profits per equity partner (PPEP) rose a solid 5.8%, one of the largest increases in profits seen in the last decade. Impressive as it was, however, the increase pales against those seen by other market segments. Am Law 100 and Second Hundred experienced double-digit gains, with PPEP shooting up 14.5% and 13.1%, respectively.

Figure 8 – Profit Per Equity Partner Growth



Rather than viewing their performance as a relative shortfall, midsize firms should consider their 2020 results as a positive step to build on to improve performance and close those gaps.

It was only four years ago that midsize firms were the top performing segment for demand. And in the two following years, midsize firms managed to outperform Am Law Second Hundred firms.

Many of the factors that contributed to the sector's success during the years may be even more pertinent now.

Midsize competitive advantages

Midsize firms are by no means homogenous; midsize firms include large regional firms, specialized boutiques, firms with multinational footprints, and more.

But by virtue of the position they occupy in the marketplace, many midsize firms possess unique advantages when competing for business. These include value, flexibility, and agility.

Data from Thomson Reuters® Acritas[7] finds that midsize firms are more frequently recognized for their value and pricing than larger firms. As mentioned earlier, by being less aggressive in raising rates, compared to larger firms, midsize firms may be strengthening their position to better provide a superior cost-value proposition. As businesses move towards a post-COVID world, their emphasis on evaluating and assigning legal work through the lens of price and value is likely to increase.

While midsize firms generally don't carry the same brand recognition as the very top tier of firms, that is not necessarily a hindrance in winning business. Not surprisingly, the largest firms hold the most top-of-mind awareness among clients, yet that awareness is generally correlated with a firm's attorney headcount — the bigger the firm, the more likely they are to have awareness among clients.

However, the Acritas findings also show larger firms are less able to successfully translate that awareness into favorability and consideration for work. In fact, as the size of a firm's headcount decreases, its ability to convert awareness of the firm into favorability increases.

Client needs are changing, and value and efficiency in delivering legal services are more prized than ever. It's incumbent upon midsize firms to seize their inherent advantages — a compelling cost-value basis, and greater agility in responding to matters — and more effectively leverage these competitive advantages.

Even amid the overall drop in demand last year, there were a few pockets of matters that suggested this dynamic may have been already underway for certain practices. Midsize firms showed slightly better demand than did firms in the Am Law Second Hundred for litigation and corporate work in 2020. And, midsize was the highest-performing segment for trusts and estate work. But, midsize firms will need to build on that momentum, as well as close the gap in other practices.

A sense of urgency and opportunity

But, the window of opportunity may be brief.

While midsize firms recorded strong profits last year, some of the factors that drove that profitability may make it more difficult to repeat that successful playbook in 2021, even with the prospect of economic recovery notwithstanding.

The spike in rates last year is likely not sustainable. And while firms were aggressive in cutting costs, there may not be further cost savings to wring out. While the rate and cost strategies were generally successful in helping midsize firms weather the challenges of 2020, they are not strategies for long-term success.

Midsize firms need to position themselves to take advantage of a potential resurgence in activity this year. As courts work their way through the logjam of cases held over from previous dockets, litigation work may finally see a much-anticipated pickup. In addition, economic slowdowns are typically followed by a boom in litigation. Following the 2008-2009 financial crisis, nearly every type of litigation matter tracked by Thomson Reuters Monitor Suite saw growth in matter volume for two and sometimes even three years after the economy began to recover.

While it's still too early to say when litigation practices will pick up again, firms need to position themselves now. If firms wait until the resurgence starts, it will be too late.

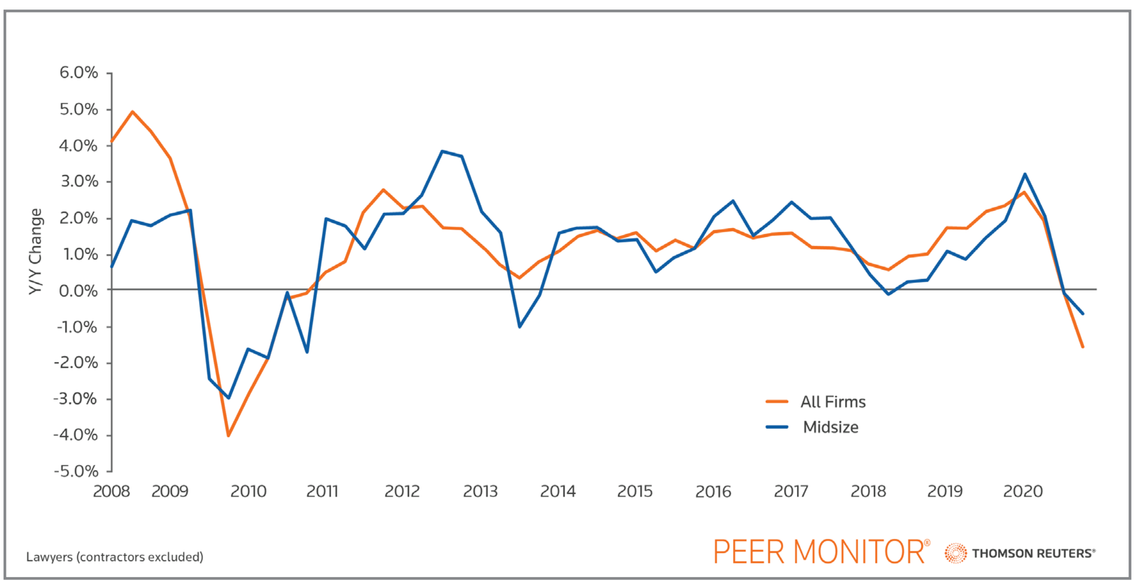
Meanwhile, the pickup in bankruptcy work may still be in its early stages. There is potential for a wave of new bankruptcy filings as many businesses may not survive despite government business relief efforts.

A need to address productivity

Midsize firms will need to closely monitor how current trends are impacting their clients, and plan effectively. That will include managing capacity even as demand improves. Midsize firms encountered difficulty balancing those factors last year as midsize firms' productivity fell 2.5% — the worst among any of the tracked law firm segments. This was largely a result of midsize firms not being as effective in matching their headcount against available work.

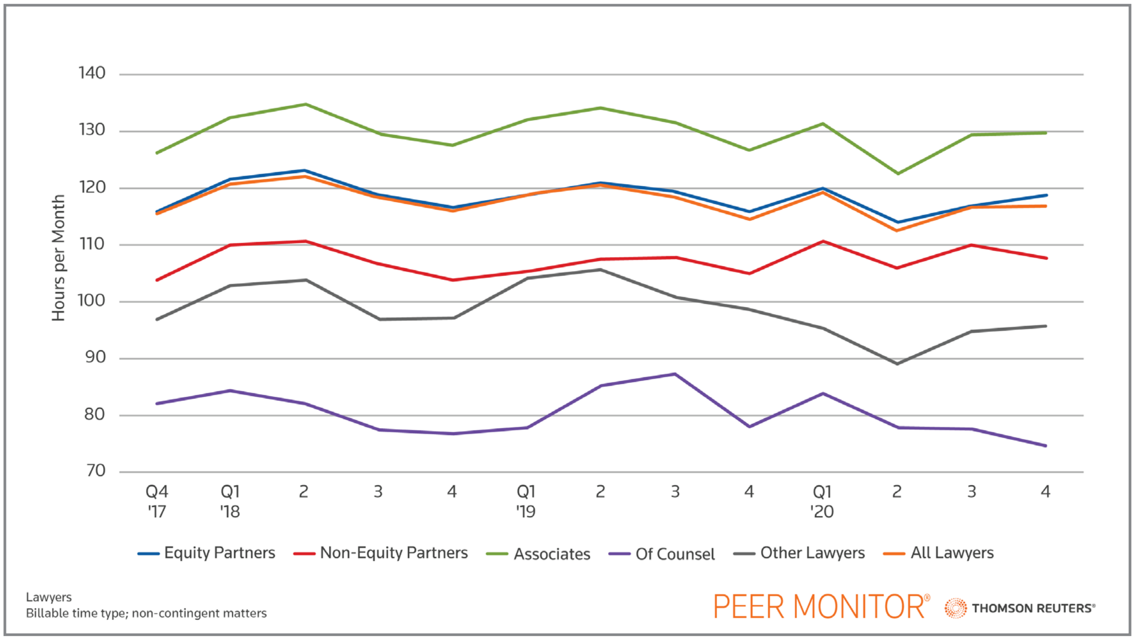
In 2018 and 2019, midsize firms had the lowest headcount growth among the market segments. But as 2020 began, midsize suddenly ramped up hiring, and had the highest headcount growth in the January-March period. As the pandemic took hold and demand dwindled, firms across the board started reducing their headcount for the first time since the financial crisis. But larger firms were more aggressive in reducing their headcount. For example, in Q4 2020, midsize headcount contracted 0.6%, while Am Law firms saw headcount reduction averaging in excess of 2%.

Figure 9 – Lawyer FTE Growth



Nevertheless, the abrupt changes of 2020 may provide an unexpected path for improving productivity. Some midsize law firms found that their associates were actually able to shore up the billable time because they were no longer commuting into the office. As firms contemplate how they will manage working arrangements going forward, such considerations need to be kept in mind.

Figure 11 – Hours Per Lawyer



Acritas data found that a significant proportion of attorneys — especially younger attorneys — are appreciating the advantages of remote working and would prefer to retain at least some flexibility or options for working from home even when offices reopen. In addition, having seen the success of work from home, resistance among senior partners to remote work is diminishing.

The uncertain road ahead

After the unprecedented events of 2020, it's not a stretch to say that 2021 will likely be a far different year in many respects. But exactly what that means is unclear.

Even if the nascent recovery in the legal market that started in late 2020 continues to gather momentum, the COVID crisis may have a lasting impact.

The 2021 State of the Legal Market Report questioned "whether the legal industry that bounces back will be the same legal industry that entered the pandemic."

Many of the changes seen over the last year, such as remote working, technology-enabled court hearings, and greater emphasis on productivity-enhancing tools, are likely to permanently alter how legal services are delivered.

After achieving notable success in adapting to the many obstacles that emerged last year, midsize firms still possess unique advantages that may allow them to thrive in a new competitive landscape that places greater emphasis on efficiency. Firms need to deploy strategies that will both bolster top-line growth as well as provide sustainable cost reductions.

To achieve that, they need to apply the lessons learned, and navigate a new way forward rather than counting on a return to business as usual. And, it will require much of the same resilience and innovation that they so successfully demonstrated in dealing with the still on-going challenges that are carrying over from the past year.

Endnotes

1. For our purposes here, midsize firms are defined as those firms participating in Peer Monitor, but not included within the Am Law 200 rankings. Thomson Reuters Peer Monitor® data is based on reported results from 162 U.S.-based law firms, including 51 Am Law 100 firms, 54 Am Law Second Hundred firms, and 57 additional midsize firms.
2. 2021 Report on the State of the Legal Market, published January 2021 by Thomson Reuters Institute and The Center on Ethics and the Legal Profession at Georgetown Law. https://legal.thomsonreuters.com/en/insights/reports/2021-state-of-legal-market
3. For our purposes, "demand for law firm services" is viewed as equivalent to total billable hours recorded by law firms during a specified period.
4. Worked rates, also referred to as negotiated rates, are the rates that a firm agrees to with particular clients for work on given matters.
5. Direct expenses refer to those expenses related to fee earners, primarily the compensation and benefits costs of lawyers and other timekeepers. Indirect or Overhead expenses refer to all other expenses of the firm, including occupancy costs, administrative and staff compensation and benefits, technology costs, recruiting expenses, business development costs, and the like.
6. The 2020 Law Firm Business Leaders Report can be downloaded at https://legal.thomsonreuters.com/en/insights/reports/2020-law-firm-business-leaders-report.
7. Acritas, part of Thomson Reuters, combines a scientific approach, market insights, and expert market researchers to create a global depth of knowledge to help law firms and legal departments drive strategy and future success. www.acritas.com.

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