



2019

Report on the State
of the Legal Market

A View from the Midsize Firms

The recently released *2019 Report on the State of the Legal Market*, produced in collaboration with the Georgetown Center on Ethics and the Legal Profession, opens with the assertion that, “when faced with mounting evidence that our traditional way of looking at a problem is no longer satisfactory...it makes sense to examine our underlying assumptions[.]”

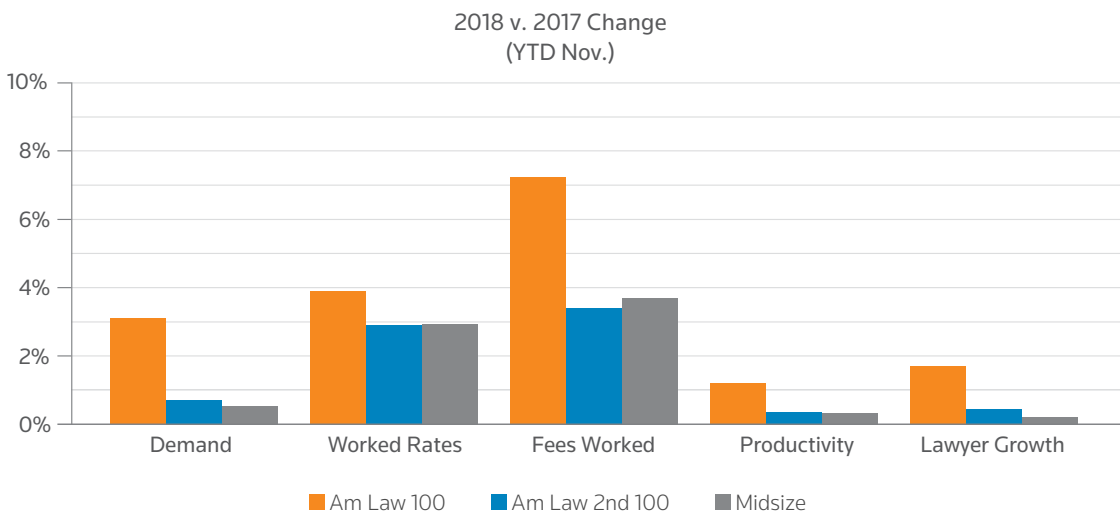
Perhaps one of the more pervasive assumptions about the legal market for the past several years is that Midsize¹ law firms cannot compete with larger firms for client business, and therefore, their growth potential is limited. Indeed, for most of the last two years, Midsize law firms struggled to find growth in such key areas as demand for law firm services and revenue.²

But 2018 showed that these Midsize firms can find solid growth, and in fact, client-driven factors influencing the future may hold even more promise for Midsize firms.

Current State of Midsize Firms – By the Numbers

Overall, the US legal market showed positive signs in 2018. The average firm in the market saw positive growth across all key performance indicators, including healthy growth in worked rates,³ and even a slight uptick in productivity,⁴ something which the market hasn’t seen since 2010.

Figure 1 – Key Performance Indicators



All timekeepers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

While not on pace with their Am Law 100 counterparts, Midsize firms similarly saw positive performance across all key performance measures (KPIs). Average demand growth of 0.5% compares quite favorably to the 1.6% contraction in average demand that Midsize firms saw in 2017. Demand for Midsize firms grew even as these firms maintained worked rate growth of 2.9%, on pace with past years. Midsize firms also managed their headcount quite effectively, averaging only 0.2% lawyer growth. This modest growth in lawyers helped turn the uptick in demand into a positive result for productivity with firms averaging 0.3% productivity growth.

¹ For purposes of this report, Midsize law firms are those who fall outside of the Am Law 200 rankings. Within the Peer Monitor sample, this accounts for roughly 65 firms, ranging in size from just outside the Am Law 200 to about 35 attorneys.

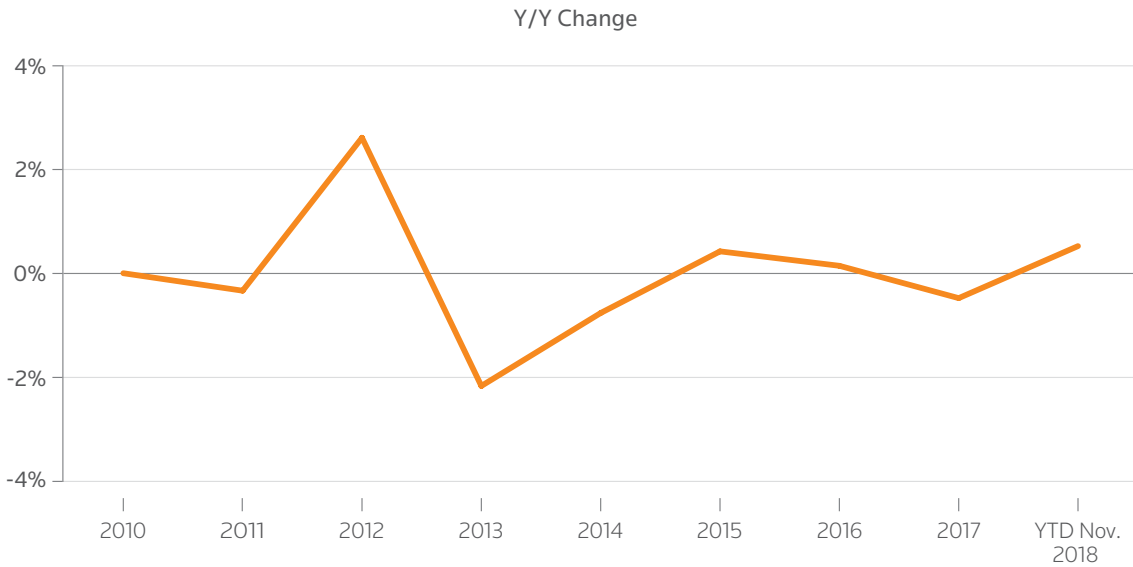
² For the purposes of this report, “demand for law firm services” is viewed as equivalent to total billable hours recorded by firms during a specified period.

³ “Worked rates” are the negotiated rates as determined by the matter value. Worked rates are often referred to as “agreed rates.”

⁴ “Productivity” is defined as the number of billable hours worked by lawyers divided by the total number of lawyers.

Placed in historical context, 2018 appears to be a much more favorable year than many years this decade. On the whole, Midsize firms have trended in a positive direction in terms of demand growth for most of the past six quarters after a dip in late 2016 through early 2017.

Figure 2 – Growth in Demand for Law Firm Services: Midsize

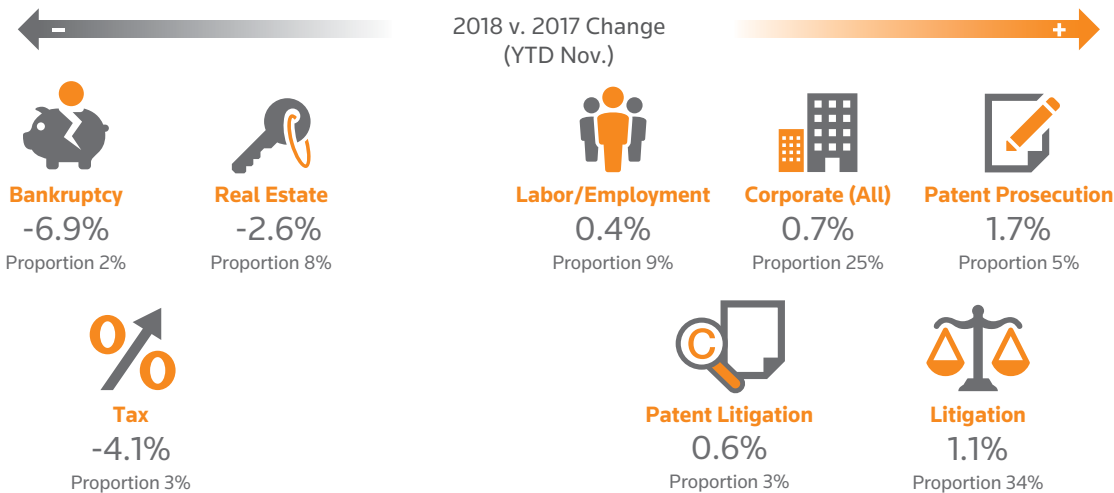


All timekeepers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

In Figure 3, we break down overall demand growth by key practice areas. Of particular interest in the 2018 results is the positive growth in litigation, something we have not seen since 2011. This is especially significant because litigation (with 34 percent of all recorded billable hours) is the largest single practice area covered by Peer Monitor® data. Moreover, more than half of all firms in the database experienced litigation growth, as did more than half of the firms in each practice segment (Am Law 100, Am Law Second 100, and Midsize).

Figure 3 – Practice Demand

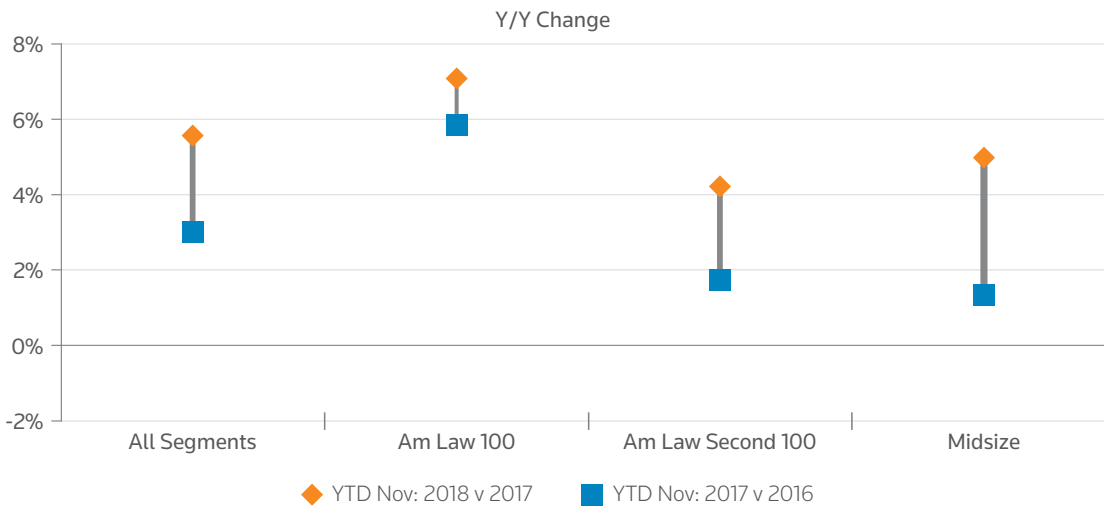


All timekeepers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

Examining this growth in demand on the basis of which practices are growing, we again see positive trends. Both litigation and corporate practice were positive for the year. With both of these major practices in positive territory, it is quite understandable why Midsize firms saw positive results. These two practices account for a full 59% of total billable hours tracked by Peer Monitor. It's true that those practices which did contract in 2018 saw relatively steep contractions, e.g., 2.6% contraction for real estate practices, but those practices represent a relatively small total proportion of total demand.

Figure 4 – Revenue



G/L revenue

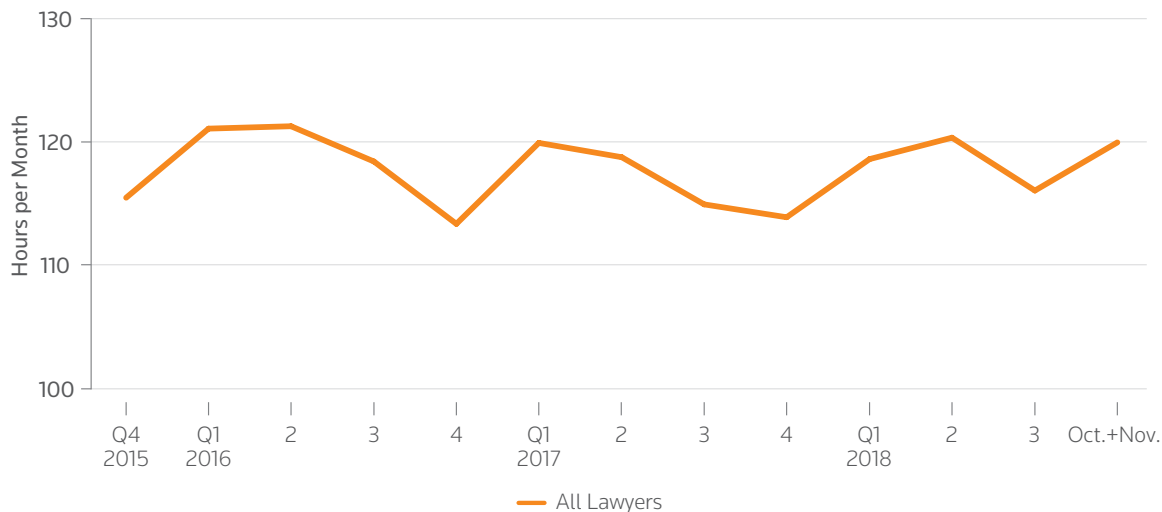
Source: Thomson Reuters Peer Monitor®

Midsize firms were able to capture this increased demand and convert it into healthy revenue growth for the year. Revenue for the average Midsize firm grew by 5.0% year-over-year in 2018, outpacing even Am Law Second Hundred firms, and putting Midsize firms just behind the All Segments average of 5.5% growth.

A Closer Look at Productivity

In our 2018 Dynamic Law Firm Study, we stated that “productivity is king.” While axiomatic, it can also be a difficult thing to convert into reality. But in 2018, Midsize firms appear to have done just that.

Figure 5 – Hours Worked per Lawyer per Month



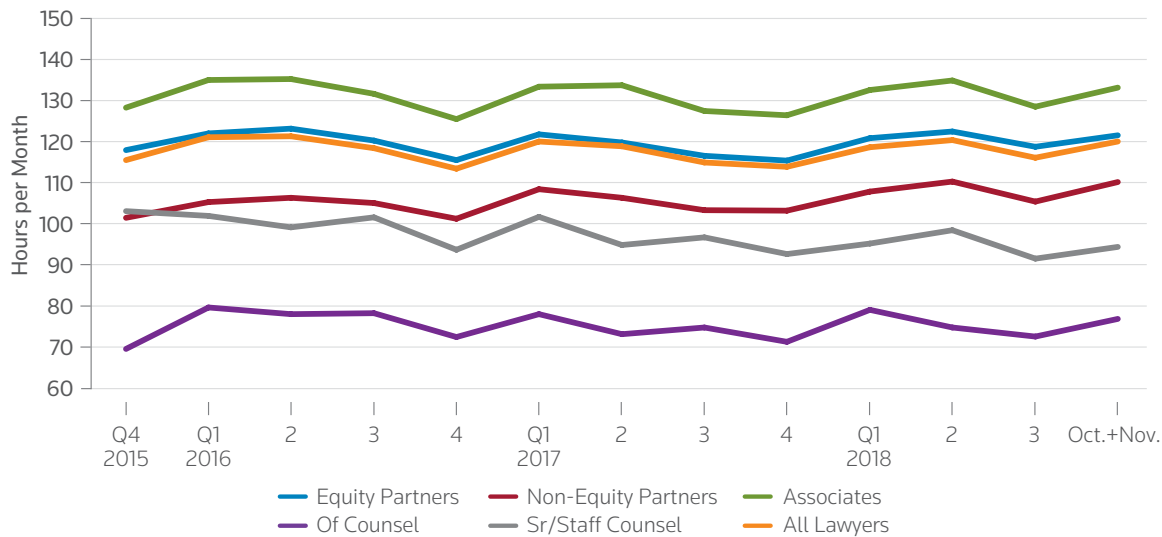
Lawyers only

Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

We've already made mention of the uptick in productivity experienced by Midsize firms throughout 2018. But looking at the historic visualization of productivity data on the basis of hours per lawyer per month, we gain an appreciation for not only the periodicity of figures like productivity but also how uncommon it is to see productivity rise in the latter half of a calendar year. Lawyers at Midsize firms averaged an equivalent number of hours in October and November 2018 as they did in Q1 of 2017, very different periods of the business cycle for most firms.

Figure 6 – Hours per Lawyer per Month



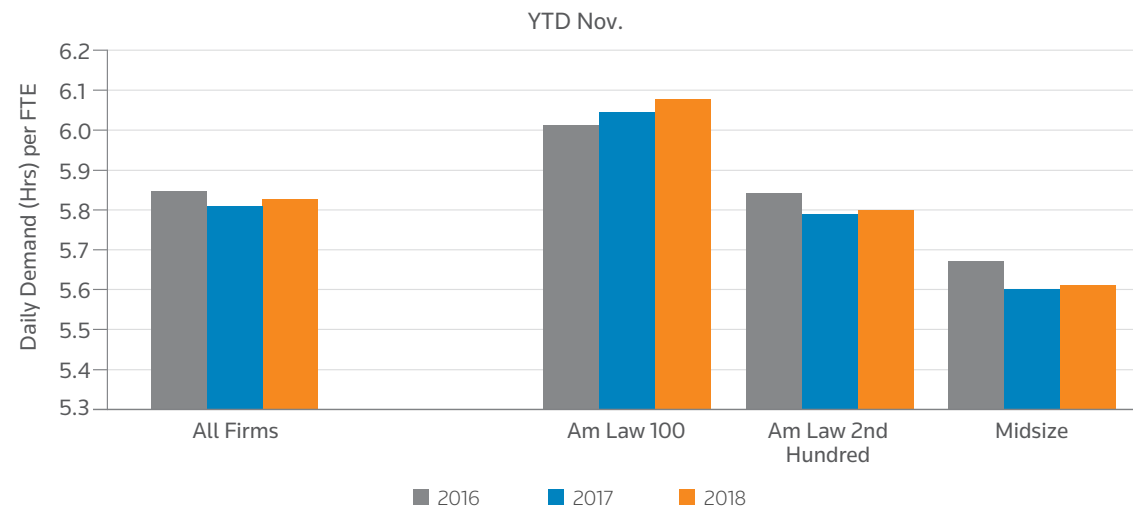
Lawyers only
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

In fact, when looked at on the basis of particular timekeepers, we see the same positive year-end tail for all timekeeper groups.

Also encouraging here is the continued high production of associates across the entire timeframe. Well-structured firms should experience some of their highest profit margins on hours produced by their associates, particularly more seasoned associates, so it is a positive sign to see these timekeepers stay consistently high in their productivity.

Figure 7 – Average Daily Demand per Lawyer



Lawyers only
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

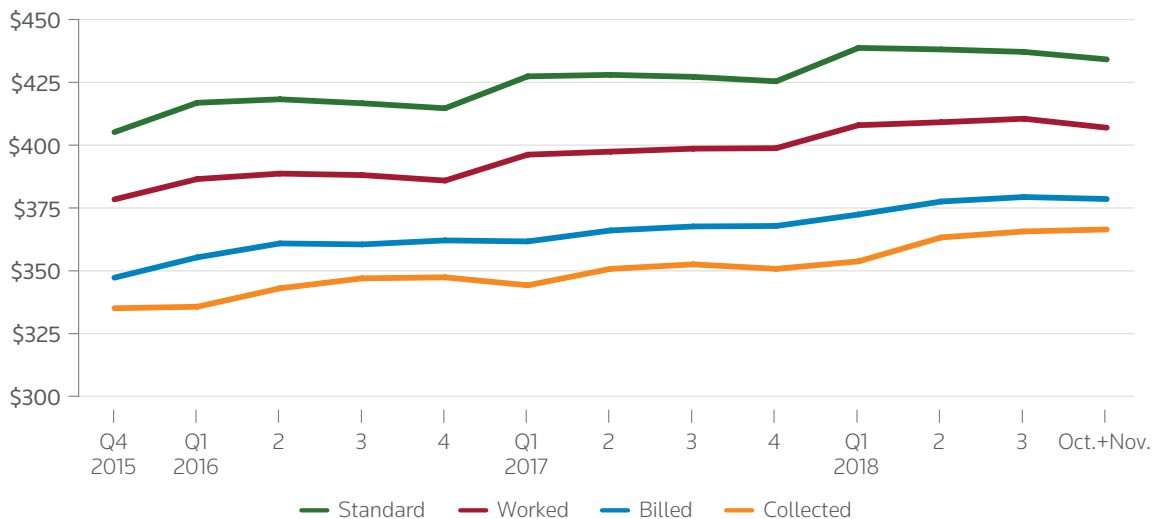
We can also examine productivity on the basis of average daily demand per lawyer. This is essentially a measure of the average number of billable hours an attorney works in a given day. It's true that Midsize firms trail behind both their Am Law 100 and Second Hundred counterparts. But perhaps the more important comparison is how Midsize firms fared relative to themselves on a year-over-year basis.

In terms of that comparison, Midsize firms were solid in 2018, experiencing an ever-so-slight uptick in average daily demand compared to 2017. Granted, Midsize firms still have some distance to go to get back to 2016 levels, but this may be a situation where, at least temporarily, "less bad is good."

Examining Rates and Realization

For 2018, Midsize firms grew their worked rates at essentially the same clip as their Am Law Second Hundred counterparts, averaging growth of 2.9%. But let's examine rate performance for Midsize firms in a bit more detail.

Figure 8 – Rate Progression



Lawyers only
Billable time type; non-contingent matters

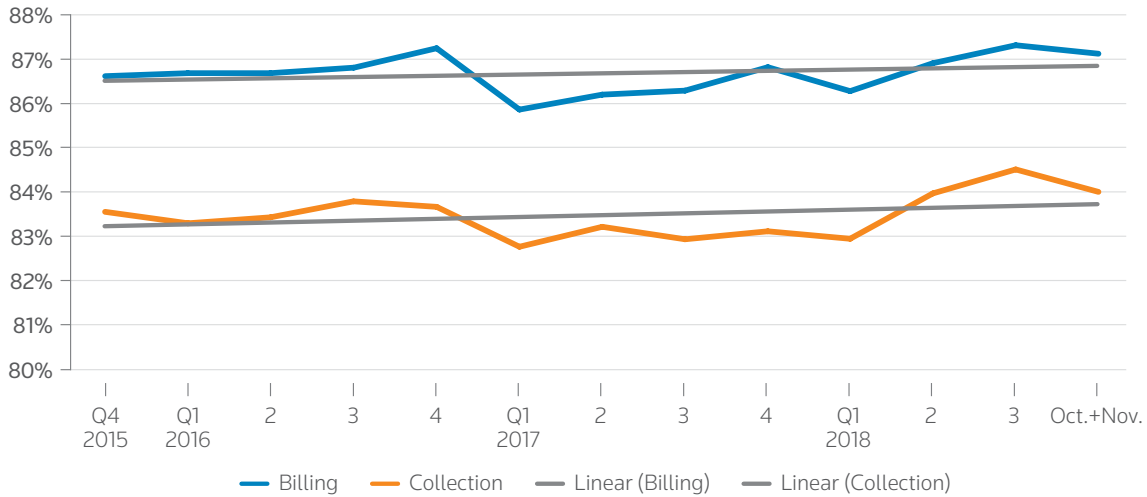
Source: Thomson Reuters Peer Monitor®

Growth in both standard and worked rates for Midsize firms has been relatively consistent for the past three years. Similarly, billed rates, the rates actually invoiced to clients have grown steadily.

But what is of note in this chart is some of the subtleties. In Q1 2017, Midsize firms saw an average discount of \$35 from their worked rates to their billed rates and another \$17 write-off from what the client was billed to what the firm collected. Even in the fourth quarter of 2017 when most firms place a strong focus on collections, the delta between worked and billed rates was at \$31 and the average amount of the write-off was unchanged. But by the latter part of 2018, the average firm saw their worked rates erode by only \$28 by the time of billing, and the write-off to the collected rate shrunk to only \$12.

There are likely myriad reasons for this curtailing of rate erosion, but it is definitely noteworthy. For most firms, it is particularly the difference between the worked rate and the billed rate that leads to the greatest declines in realization. Controlling this pre-bill discounting can be vital to maintaining or even improving realization.

Figure 9 – Realization Against Standard

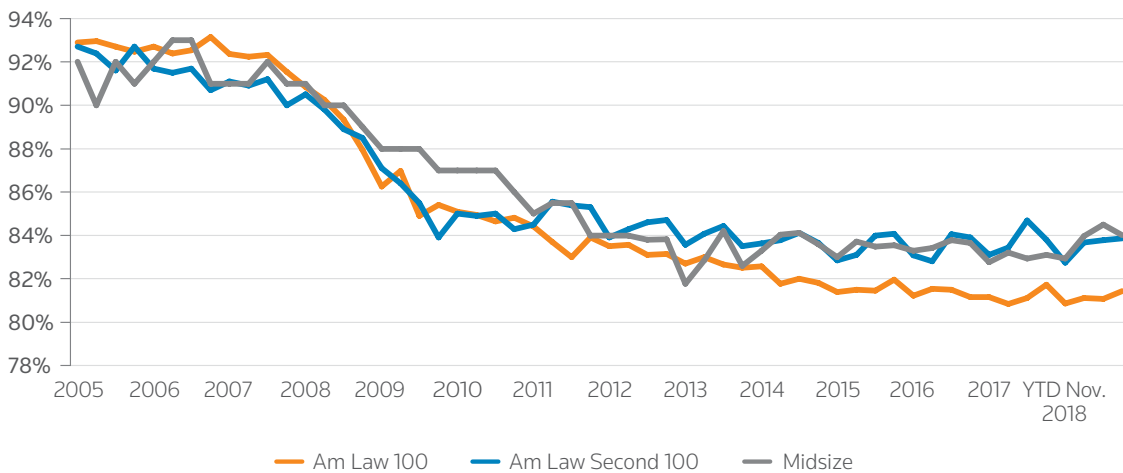


Lawyers only
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

For both billing and collection realization, it is quite encouraging to see positive trendlines, even despite some periodic volatility in both figures. For much of this decade, firms have seen realizations steadily decline. That Midsize firms seem to have stabilized, if not improved their realization rates is no mean feat.

Figure 10 – Collection Realization against Standard



Lawyers only
Billable time type; non-contingent matters

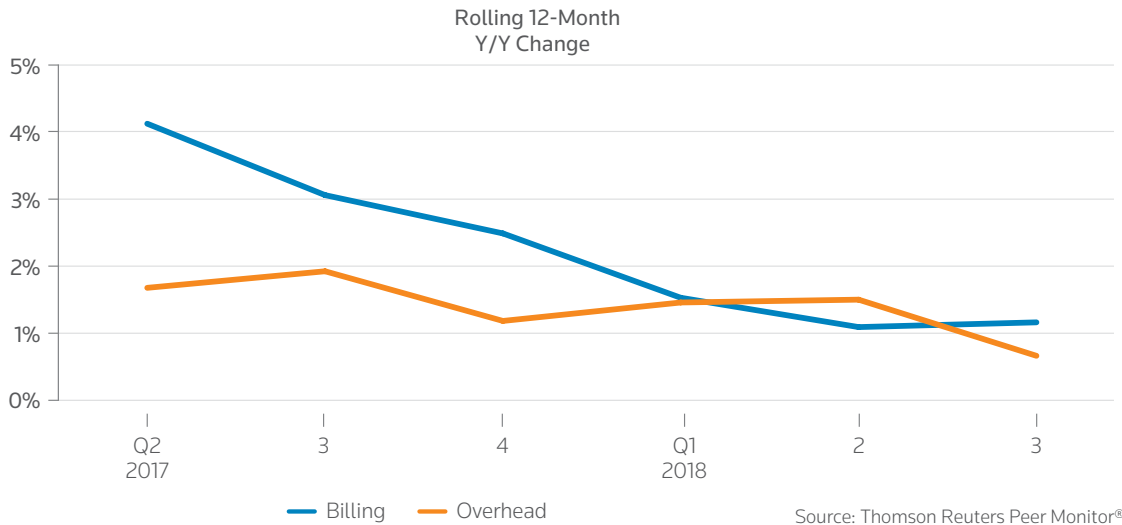
Source: Thomson Reuters Peer Monitor®

Midsize firms continue to be among the strongest performers in terms of their collected realization against their standard rates, leading the market in terms of collected realization for all of 2018.

Expenses and Investment

Throughout the past six quarters, Midsize firms have been quite deliberate with regard to their expenses.

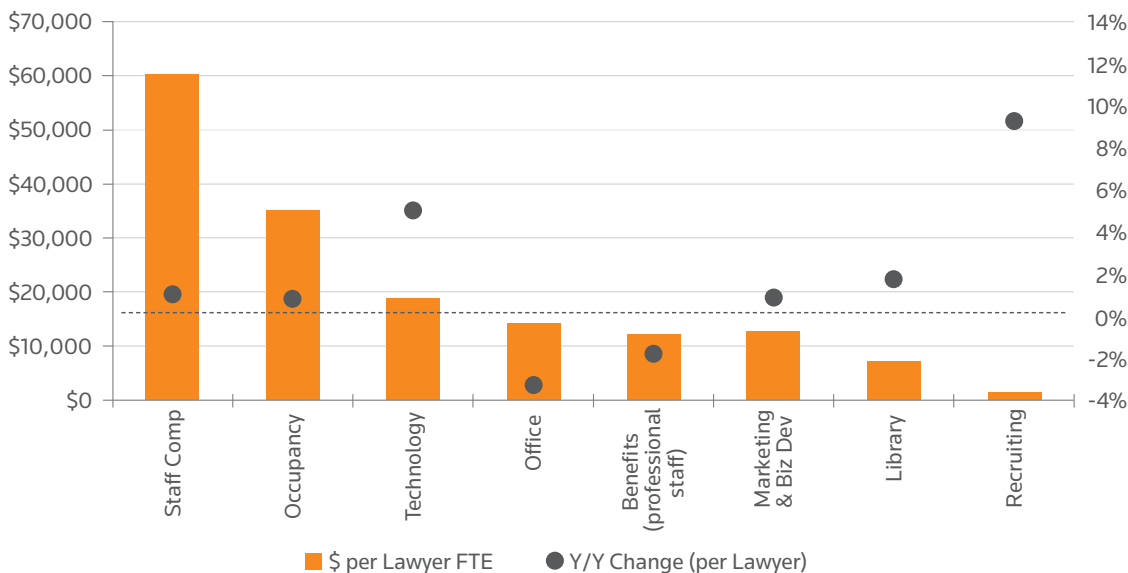
Figure 11 – Expense Growth



In Q2 2017 direct expenses for Midsize firms grew by 4.1%. That growth shrunk to only 1.2% in Q3 2018. Similarly, overhead expenses were growing at 1.7% in Q2 2017, but was reined in to only 0.7% in Q3 2018.⁵

In terms of investment focus, the single most significant area of increased investment for Midsize firms was in technology. Both recruiting and professional expenses grew at higher rates than did technology spending, but those two categories combined account for only 1.3% of total expenses tracked, compared to the 11% for technology.

Figure 12 – Overhead Detail per Lawyer by Category*



*Rolling 12 months, through Q3 (Q4 2017-Q3 2018)

Source: Thomson Reuters Peer Monitor®

⁵ "Direct expenses" refer to those expenses related to fee earners (primarily the compensation and benefits costs of lawyers and other timekeepers). "Indirect 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).

When examined on a per lawyer full-time equivalent (FTE) basis, we again see how increased investment in technology outpaced nearly every other category. Midsize law firms increased their investment in technology by 5.0% per lawyer FTE over the past 12 months, spending just slightly more than \$18,600 per lawyer FTE on technology.

Technology is indeed a wide umbrella, so it is difficult to say with certainty what sorts of technology these firms are focused on with their increased investments. However, based on a large number of conversations with Midsize firms throughout the year, we are confident in saying that many of these investments are likely focused on areas related to practice and matter management as well as law firm operations. We frequently hear from Midsize firms about their desire for a better understanding of their financial performance and profitability, as well as for greater efficiency in their client service delivery.

Successful Midsize Firms Going Forward

In the introduction, we stated that client-driven factors may hold promise for Midsize firms in the future. But this will not happen without active participation on the part of Midsize firms.

The US legal market as a whole saw positive performance in 2018. But the market remains incredibly tight. For most firms, demand is a zero-sum game; for one firm to win new business, another firm must necessarily lose a client or matter. Factor in increasing competition from alternative legal service providers (ALSPs), and the market becomes even more competitive. Indeed, as reported in State of the Legal Market report, the overall ALSP market grew by an estimated 20% from 2016 to 2018.

For Midsize firms to remain competitive in this environment, they must continue to do some of the things they've become adept at in the past few years.

- Prudent management of expenses will remain important, but firms must also be cautious to not over-manage their expenses to the detriment of strategic investments.
- Rates will continue to be vital. Firms must find a balance point where rate growth supplies the needed additional revenue to support firm growth and strategic direction, while not losing sight of the fact that many clients prefer Midsize firms for certain types of matters due to their favorable cost structures.
- Lawyer growth must be carefully managed. It is vital to have sufficient leverage to push work down and enable succession planning, but firms should be careful to conflate lawyer growth with demand growth. Lawyer growth that outpaces demand will deplete productivity.

But Midsize firms must also learn a few new tricks. In the State of the Legal Market report, chief author Jim Jones of the Georgetown Center on Ethics and the Legal Profession introduced the concept of the Dynamic Market Model. As explained in the report, only about one quarter of the total legal market involves work that calls for truly unique legal expertise. The vast majority of legal work falls into what is categorized as either comprehensive legal services or ancillary support services. The further down the spectrum a particular type of work falls, the less important the value of legal skill becomes, and the more price and value conscious the client becomes, thereby increasing the level of competition for the work.⁶

Like their larger counterparts, Midsize law firms looking to understand their place in this model will need to carefully and honestly examine their practices in terms of some key questions:

- (i) How truly valuable is the service from the client's perspective?
- (ii) How novel or unique is the proposed service or the solution required?
- (iii) How important is unique legal expertise in addressing the problem or issue involved?
- (iv) How concerned is the client about efficiency, cost effectiveness, or predictability in the delivery of the service?
- (v) How likely is the client to disaggregate the desired service, *i.e.*, to divide the work up among a variety of law firms or other service providers (including in-house lawyers)?
- (vi) How price sensitive is the matter?

⁶ For a full discussion of the Dynamic Market Model, see the *2019 Report on the State of the US Legal Market*: www.legalexecutiveinstitute.com/2019-legal-market-report/

Clearly, there will be a mix of answers to these questions for most firms based on the nature of the practice, or for some practices based on the particular client served. It is not an insignificant challenge.

But firms that can stake out their place in the model can gain deeper insight into where they may be able to make improvements to become more competitive.

At the outset of this report, we stated that one assumption some might make about Midsize firms is that they are not capable of growth at the same levels as Am Law 100 or Second Hundred law firms. Yet evidence indicates that is simply not true.

In our *2018 Dynamic Law Firms* study, we segmented the entire Peer Monitor population on the basis of compound annual growth performance on three financial metrics: revenue per lawyer, overall firm profit, and overall average firm profit margin. Those firms that saw the best rates of growth across those three metrics became our Dynamic law firm population. Fully one-third of those firms classified as Dynamic law firms were Midsize firms.

Firms of any size, from any region in the country, can create conditions for market-leading growth with concerted strategy and careful management. Midsize law firms enjoy many advantages in the market: they are viewed as more cost effective; they are often more nimble; expertise does not have to suffer simply because of smaller scale. These are all factors which clients value. Those Midsize firms that can position themselves to be seen as catering to these desires on the part of their clients will be well situated for success in 2019 and beyond.



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