The law firms' survey 2009

PricewaterhouseCoopers

Executive summary

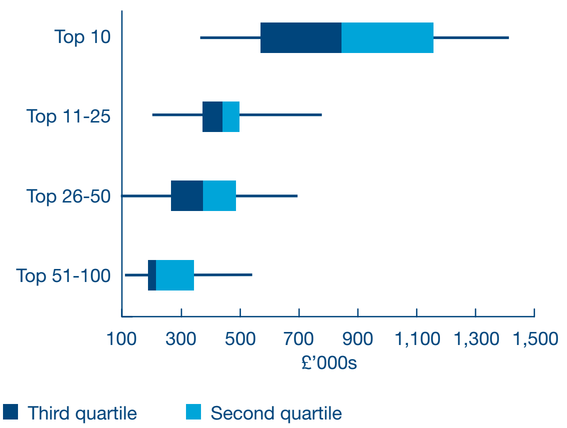
This year has seen the greatest turmoil in the law firm sector since our survey began in 1991. At the time of last year's survey in October 2008, the global financial markets were beginning their post Lehman free-fall and it was clear that law firms would not be immune from the effects of this crisis. It is fair to say, however, that the level of impact of those events was not anticipated.

It was clear last year that there would be 'winners and losers' and this is confirmed by the wide variation in performance evident in this year's survey. We have therefore focused on quartile performance as well as averages this year in order to give the reader a better appreciation of relative performance.

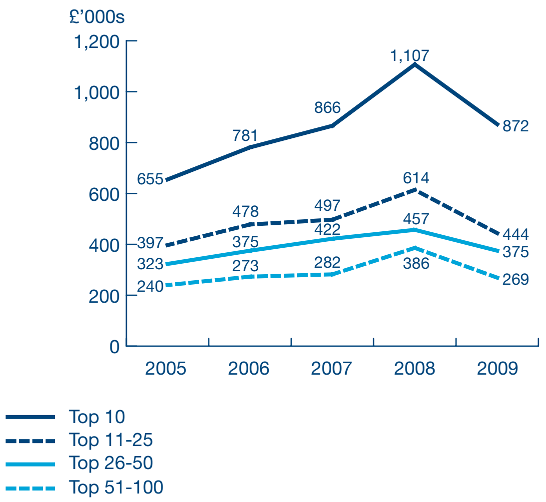
Significant reductions in profits per partner have already been extensively reported in the press, and our survey confirms that most firms have seen a fall in profits per partner. What the survey further reveals however is that despite falls in profits per partner of on average up to 30%, performance has varied significantly amongst the size categories of firms. The Top 10 firms have maintained their relative breakaway performance despite a 21% average fall in profits per partner. Average profits per partner amongst the Top 10 at £872,000 were almost twice the average profits of Top 11-25 firms (£444,000). Analysing this further, we see clear daylight emerging within the Top 10, with half of these firms recording average profits per partner of between £850,000 and £1.4m. This is significantly better than the chasing pack, pointing to an earlier focus by these firms on cost reduction and restructuring.

Top 11-25 firms have, on average, experienced the greatest challenges with the result that there is now a much reduced difference in terms of profitability amongst the Top 11-25 firms and the Top 26-50 firms.

Range of profits per partner – UK



Profits per partner



The reasons for the relatively weak performance amongst the Top 11-25 firms appears clear. It is this category of firms who have:

- Seen the greatest average fall in UK income
- Been operating in the most competitive and depressed markets, e.g. transactions, property and UK corporate
- Held equity partner headcount at 2005 levels running against the trend for all other size categories of firms (e.g. Top 10 have reduced partner numbers by on average 10% since 2005)
- Reduced fee earner numbers by, on average, the least of all size categories of firms.

Although mergers have been widely predicted for a number of years, our survey shows a muted appetite for merger despite economic conditions. However, given the difficulties for the Top 11-25 firms, it is perhaps not surprising that half of this banding anticipate that a merger is 'fairly likely' within the next 2-3 years.

Another interesting result from the survey has been the extent and impact of staff headcount and other cost reduction programmes. A relatively small number of firms rightly predicted the likely extent and severity of the economic recession and began to reduce headcount and take out cost early in the second half of FY09. Despite these firms having felt the early impact of redundancy programmes, the cost of which was on average 1.4% of fee income for Top 10 firms, we expect these firms will be better placed to weather the continuing difficult economic conditions during FY10.

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Our survey shows that business confidence remains weak amongst managing partners with none of the Top 10 firms 'very confident' about prospects for revenue growth over the next 12 months. Where growth is anticipated it is overwhelmingly from a better penetration of existing markets rather than new service innovation, new markets or M&A activity. It appears that this focus on existing markets is contributing to acute pricing pressure within the UK market for legal services.

Against a backdrop of continuing challenging economic conditions and chargeable hours falling by up to 20%, we expect to see some firms being forced to continue with staff headcount reductions in FY10. Across many grades of staff, chargeable hours are now running at levels below that of 2006. Perhaps the worst affected grade was newly qualified staff in Top 10 firms, where chargeable hours fell by 19.7% to an average of 1,141 hours (compared to 1,400 hours in 2006). Whilst staff salaries have remained static for qualified lawyers, bonuses have continued to be paid and indeed have generally increased compared to 2008. One possible reason for this might be firms paying bonuses as an alternative to a rise in salary (and thereby avoiding an increase in their fixed cost base).

With the increasing importance of international operations for law firms we asked a series of more detailed questions on international performance for this year's survey. The results show a significant growth in the proportion of fees generated from international operations across all size categories of firms. Three quarters of all Top 10 firms now generate more than 40% of total fees from international operations. Whilst international fee income growth was generally very strong (aided substantially by currency movements), profit performance was mixed. Approaching one quarter of Top 10 firms and half of Top 11-25 firms experienced falls in international profits of more than 10%. This has been driven by deteriorating profit margins for international operations, particularly in Central & Eastern Europe, the Middle East and Asia and the Far East. Again we note a significant disparity of performance amongst firms with, for example, profit margins for Top 10 firms operating in the Middle East varying between 56% and -31%.

Last year we expected lock up would be an important area of focus for law firms during a recessionary period. It is therefore pleasing to report that lock up has fallen for Top 10 firms (an average of 124 days compared to 132 days in 2008). This is primarily due to significantly reduced WIP levels more than offsetting an increase in debtor days. The Top 11-25 firms remain the best performing group with average year end lock up at 105 days, well below our benchmark level of 110 days. Increased levels of debtors across most firms does represent a cause for concern, however, and should be an area for renewed focus, especially amongst those practice groups with clients most affected by the recession.

Despite the focus on effective working capital management, a significant number of law firms required partners to increase their capital during the year with half of the Top 10 firms and approximately two thirds of all other firms making a capital call.

Turning to other non-financial aspects of the survey, we found clear evidence of an increasing trend towards outsourcing across a range of business support functions. For those firms who have yet to outsource more 'traditional' areas (e.g. facilities management, travel, payroll, IT, etc) most are considering outsourcing in the near future. We also saw strong indications of intent to outsource areas such as accounting, HR and procurement processes. Surprisingly, we found little evidence of an appetite for legal process outsourcing in this year's survey. With many new players entering this market, we anticipate that this will become a growing area for firms.

Sustainability is now firmly established as a mainstream issue for legal firms. For larger firms, linking corporate responsibility strategy to core business strategy has become a key feature. However, this has less importance amongst mid-tier and smaller firms compared to basic CR issues such as employee well-being. External reporting of sustainability continues to improve, but is still lagging behind other sectors.

Looking ahead through 2010 and beyond, we believe structural change in the UK legal profession is clearly underway. The catalyst of the recession has led firms to focus on becoming more efficient, reducing cost by structural change in addition to significant headcount reductions in fee earners and support staff.

Fierce competition has caused firms to think about how they become distinctive in the eye of the client. Client relationship and engagement management, sustainability and innovative delivery models are all fast moving up the agenda. In current markets there are fewer clients and panels and there is real competitive pricing pressure. The recession has put some firms' operating models under severe stress and clear winners are beginning to emerge. For others, survival may prove challenging if there is not a rapid improvement in market conditions.