26th Annual Law Firms' Survey

Time for change
PwC Law Firms' Survey 2017

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This is the 26th PwC survey on law firms. The editorial team for 2017 consists of:

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David leads our Law Firms' Advisory Group (LFAG). He works closely with and advises national and international law firms on all aspects of their accounting, finance, strategy and business issues.

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Our Law Firms' Advisory Group harnesses the expertise of specialists nationally and internationally to provide assistance with:

- Cost reduction and outsourcing
- Assurance and business advisory services
- Compliance with SRA Accounts Rules and associated regulatory requirements
- Mergers and acquisitions
- Direct and indirect taxation
- Working capital management
- Limited Liability Partnerships (LLPs) and other structuring advice
- Partner reward
- Strategic consultancy
- Employee and employer issues (reward structures and taxation)
- International taxation and accounting
- International restructuring
- International secondments
- Internal audit and other risk management services; for example, cyber and information security.

We would like to thank all other members of the LFAG who helped with this year's survey, particularly Emma Charlesworth, David Thurkettle, Charlie Mirrington, Jasmine Martin, Tom Oliver, Catherine Usher, Qian Song, David Baxendale, Lindsay Grindall, Joe Fox and Jeremy Howard who contributed significantly to the production of this report.

Foreword

The survey results are presented by size of firm using the bandings Top 10, Top 11-25, Top 26-50 and Top 51-100 (except where otherwise stated). The classification is by annual global fee income.

Our report is based on survey responses from firms at consistent response rates to prior years. We have also drawn upon selected information from our quarterly survey and, where relevant, other published financial information.

This summary document focuses on the key findings from our survey. This year, all key data and charts are available through our online tool which participants are able to access.

Our thanks are due, as always, to the firms which participated in this survey.
We appreciate that the questionnaire takes considerable time to complete. All of the responses are processed in full and we have a significant amount of data that is not fully reproduced here or in the online benchmarking tool. If you would like further information in relation to the responses to any of the questions please contact one of our editorial team.

Definitions

US top tier – US headquartered firms where global revenues exceed £1bn (prior year restated to 2017 exchange rates for comparability).

UK top tier – UK headquartered firms where global revenues exceed £1bn (prior year restated to 2017 exchange rates for comparability).

Global Top 10 – Top 10 (by global revenue) UK headquartered firms where international revenue exceeds 20% of total revenue.

Global Top 11-50 – Top 11-50 (by global revenue) UK headquartered firms where international revenue exceeds 20% of total revenue.

UK – Operations of all UK offices only.

International – Operations of all international offices only.

Bandings – With the exception of global bandings: Top 10, Top 11-25, Top 26-50 and Top 51-100 firms have been categorised by global fee income.
The analysis for these bandings of firms has been adjusted to exclude high volume firms where their impact is considered significant.

Contents

Introduction and key themes

Introduction

Last year's Law Firms' Survey, being the 25th anniversary edition, looked back over the period since 1991 and described law firms having 'stood the test of time', surviving and prospering as many did through that period. However, as we move through and beyond 2017, we believe the pace of change will accelerate. The impact of new competition is growing, and the exchange rate volatility we have witnessed this year has given US rivals an even stronger hand in competing for talent. But perhaps the biggest challenge comes in recognising and preparing for the impact that technology will have. Changes are already underway, and it is clear that technology will impact all aspects of law firm operations, from clients, to business support and, importantly, staff recruitment and retention.

Set against this challenging background, our 2017 Law Firms' Survey reports that in many respects law firm performance has plateaued, if not declined. With profitability under pressure, and with a digital revolution inevitable for professional services firms, fundamental action is needed to future-proof the shape and operation of the firm. Our message for this year is 'time for change'.

The global picture

This year's survey has seen modest growth on a global basis. UK fee income has increased by only a few percentage points, with international expansion contributing more significantly to the overall global picture.

Global law firms headquartered in the UK have benefitted from Sterling weakening across a number of currencies following the Brexit vote in June 2016, and ongoing economic uncertainty has only weakened it further. Top 10 firms, for example, have seen average global fee income rise by almost 5% due to movements in foreign exchange, and profit has benefitted by 4.4% – or around £33k per partner. Such levels of FX volatility have given firms pause for thought in terms of managing exchange risk, in particular where it impacts on partner remuneration.

Debate continues around what is the right international strategy. Those firms who have invested in emerging markets are reaping the benefits in terms of top line growth, which is valuable in the context of a flat and over-lawyered domestic market. The US remains highest on the list of territories for UK firms to build their presence, with China and Africa also cited as being areas of interest.

But whilst profitability from international operations has improved this year, there continues to be a significant difference in the net profit margins achieved in the UK compared to international offices. This is a key strategic area for firms to keep under review, taking into account the relative maturity of the international office network and the wider risks and rewards of having a presence in a particular territory.

Of course, differing levels of profitability can be mitigated by structural choices – for example, a 'verein' or 'best friends' arrangement as opposed to a fully integrated global partnership. Differential reward structures, such as using capped lockstep ladders in lower profitability territories, are also proving useful to some in maintaining fairness of profit sharing.

Despite the UK top tier realising improved KPIs, which have in part been impacted by movements in foreign exchange, they are still significantly short of the US top tier performance. For example, fees per fee earner in US top tier firms of £678k is 67.8% ahead of UK top tier performance of £404k. This difference grows to 98.1% for the profit per fee earner statistic (US: £321k, UK: £162k).

The reasons for the significant performance differences will be many, but no doubt the biggest contributors are rate per hour and utilisation. It is well documented that the US top tier firms achieve far better results in these two key areas when compared to the UK top tier.

Impact of currency movements on global results

	Average global fee income 2017 (£'m)	Average global fee income 2017 (£'m) – at 2016 exchange rates	Impact on global fee income (%)	Global fees per (all) partner 2017 (£'000)	Global fees per (all) partner 2017 (£'000) – at 2016 exchange rates	Impact on global fees per (all) partner (%)	Global fees per fee earner 2017 (£'000)	Global fees per fee earner 2017 (£'000) – at 2016 exchange rate	Impact on global fees per fee earner (%)
Top 10	930.7	887.0	+4.9%	1,949	1,858	+4.9%	379	362	+4.7%
Top 11-50	205.1	198.8	+3.2%	1,039	1,007	+3.2%	281	272	+3.3%

	Average global profits 2017 (£'m)	Average global profits 2017 (£'m) – at 2016 exchange rates	Impact on global profits (%)	Global profits per (all) partner 2017 (£'000)	Global profits per (all) partner 2017 (£'000) – at 2016 exchange rates	Impact on global profits per (all) partner (%)	Global profits per fee earner 2017 (£'000)	Global profits per fee earner 2017 (£'000) – at 2016 exchange rate	Impact on global profits per fee earner (%)
Top 10	380.7	364.5	+4.4%	790	757	+4.4%	151	144	+4.9%
Top 11-50	69.3	67.4	+2.8%	338	329	+2.7%	91	88	+3.4%

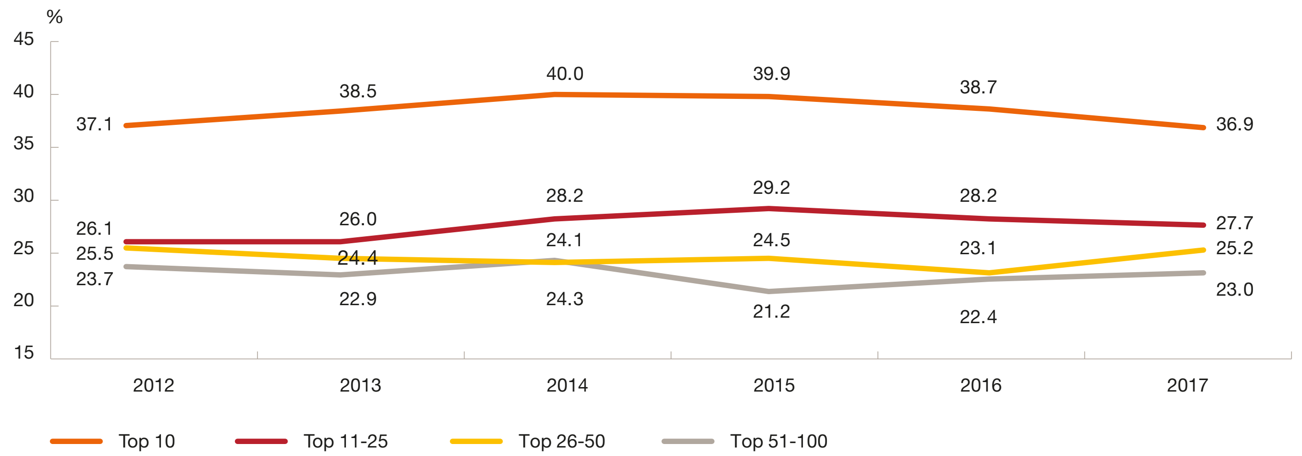
UK financial performance

Ongoing challenges to the growth in UK law firm performance remain evident in an increasingly competitive market. These challenges include (i) clients' changing demands; (ii) the ongoing threat from US firms increasing their footprint in the UK market; and (iii) new entrants and technologies. Add to that the Brexit decision in June 2016 and increasing pressure on fee earner salaries, it is clear that the landscape in the UK legal sector remains challenging.

These challenges are evidenced in our survey as:

- **Fees are under pressure.** Whilst at least 70% of law firms across our bandings achieved fee income growth, this was limited to an average increase of between 2.3% and 3.7% across the bandings. Pricing remains a key challenge and, whilst there has been some upward movement in average rates per hour, we don't view this as indicative of any real sustained increase in rates agreed with clients. The move towards fixed fees continues relentlessly, now accounting for more than a quarter of work in Top 25 firms. Firms continue to cite significant gaps in pricing behaviours versus desired practice, and the number of firms reporting unplanned fee income write-offs of 15-20% has further increased.
- **Staff costs are growing.** There is a pressure to increase fee earner salaries in order to retain and attract new talent. In Top 10 firms, staff cost as a percentage of fee income grew from 36.7% to 38.5%, and Top 11-25 firms saw a similar direction of travel from 40.6% to 42.5%. This continues a trend we've seen over the last three years, representing a reduction in profit of £200k per partner for the biggest firms over that period.
- **The impact on profit margins.** Almost half of all firms experienced a fall in profits. Average profit margin in Top 10 firms fell for the third consecutive year to 36.9% and is now lower than in 2012. Top 11-25 firms' average margin also fell for the second year, from 29.2% in 2015 to 27.7% in 2017. Whilst in certain firms PEP has been maintained, this is largely as a result of managing partner headcount.

Trend in UK net profit margins



Note: Top 26-50 firms increase in margin is down to mix of firms. Like for like, there is a 0.2 percentage points increase with the majority of impact through staff cost ratio.

Average percentage profit and loss account

	Top 10		Top 11-25		Top 26-50		Top 51-100	
	2017	2016	2017	2016	2017	2016	2017	2016
	%	%	%	%	%	%	%	%
Fee income	100	100	100	100	100	100	100	100
Staff costs – fee earners	25.5	24.3	28.2	27.1	27.6	27.9	31.1	29.7
Staff costs – non-fee earners	13.0	12.4	14.3	13.5	14.7	14.5	14.5	13.1
Property costs	8.5	8.4	8.3	9.0	8.3	9.8	8.0	7.9
IT revenue costs	3.0	2.4	3.2	2.6	3.6	3.0	3.3	2.5
Marketing & BD costs	1.4	1.5	1.9	2.0	2.5	2.0	3.0	2.4
Finance function costs	1.0	0.5	0.8	0.8	1.0	0.9	0.8	0.9
Depreciation	2.1	1.9	2.2	2.4	2.0	2.2	1.7	2.0
Insurance costs	1.2	1.1	1.4	1.1	1.9	1.8	2.1	2.2
Bad debts and disbursements	0.9	0.9	1.0	1.1	0.9	1.2	0.8	1.2
Foreign exchange differences	0.4	N/A	(0.1)	N/A	(0.2)	N/A	0.0	N/A
All other costs	2.5	4.2	4.8	7.0	4.0	4.2	5.1	8.2
Profit before fixed share equity remuneration	**40.5**	**42.4**	**34.0**	**33.4**	**33.7**	**32.5**	**29.6**	**29.9**
Fixed share equity partners' remuneration	3.6	3.7	6.3	5.2	8.5	9.4	6.6	7.5
Net profit margin	**36.9**	**38.7**	**27.7**	**28.2**	**25.2**	**23.1**	**23.0**	**22.4**
Staff cost ratio (all staff costs)	*38.5*	*36.7*	*42.5*	*40.6*	*42.3*	*42.4*	*45.6*	*42.8*
Staff cost ratio (all staff, inc. FSEP costs)	*42.1*	*40.4*	*48.8*	*45.8*	*50.8*	*51.8*	*52.2*	*50.3*

Average UK fees and fee earner cost per chargeable hour

	Top 10			Top 11-25			Top 26-50			Top 51-100		
	2017	2016	Change	2017	2016	Change	2017	2016	Change	2017	2016	Change
	£	£	%	£	£	%	£	£	%	£	£	%
Fee income per chargeable hour (all hours)	297	283	+4.9	256	238	+7.6	210	203	+3.4	178	194	-8.2
Fee earner costs per chargeable hour (all hours excluding full equity partners)	(95)	(89)	-6.7	(94)	(87)	-8.0	(80)	(86)	+7.0	(75)	(83)	+9.6

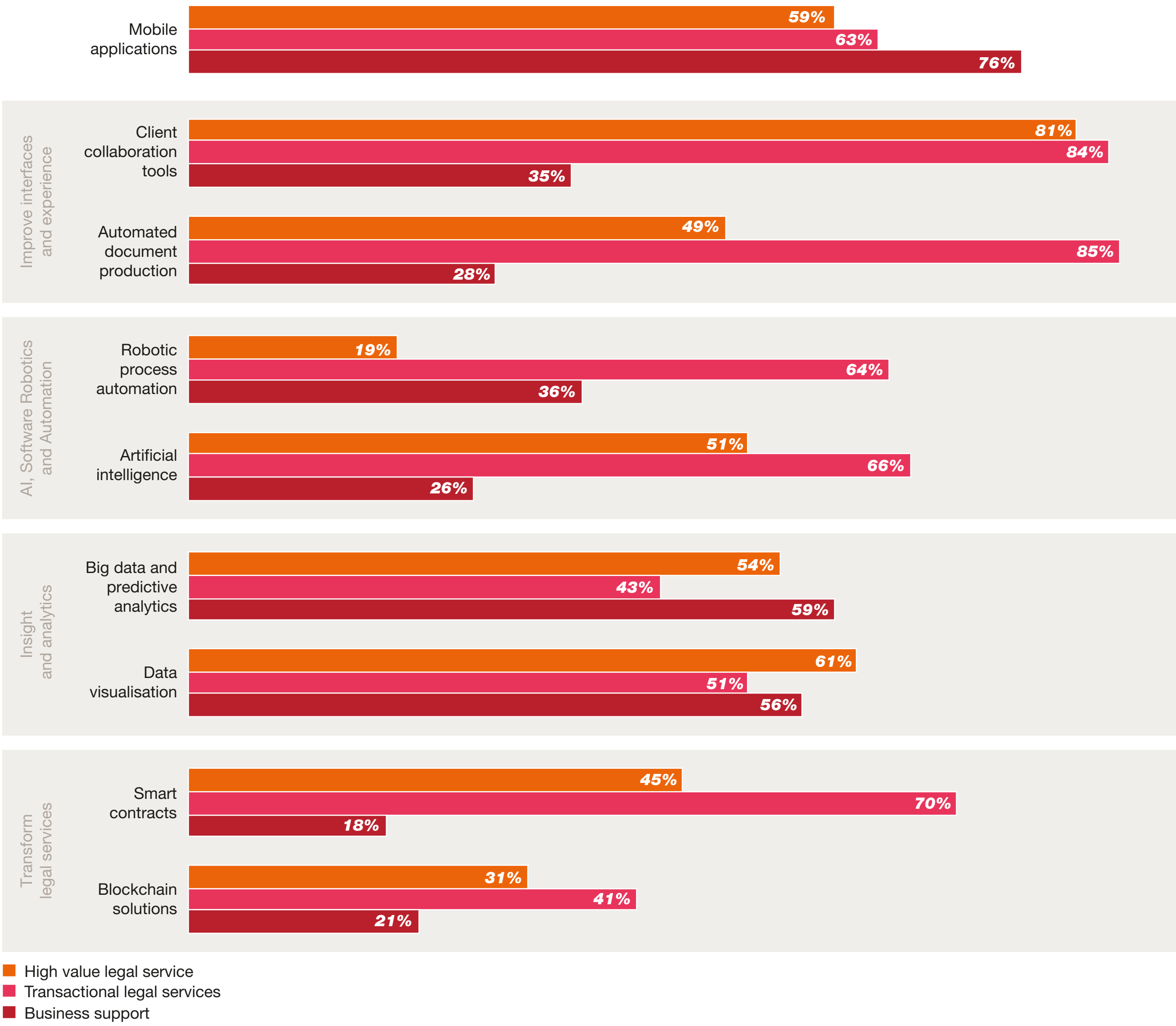
Business support

In the face of growing pressure on profits and rising staff costs, firms remain focused on improving efficiency, with key business support priorities for a third successive year being to 'improve use of technology' and 'standardise and centralise processes'.

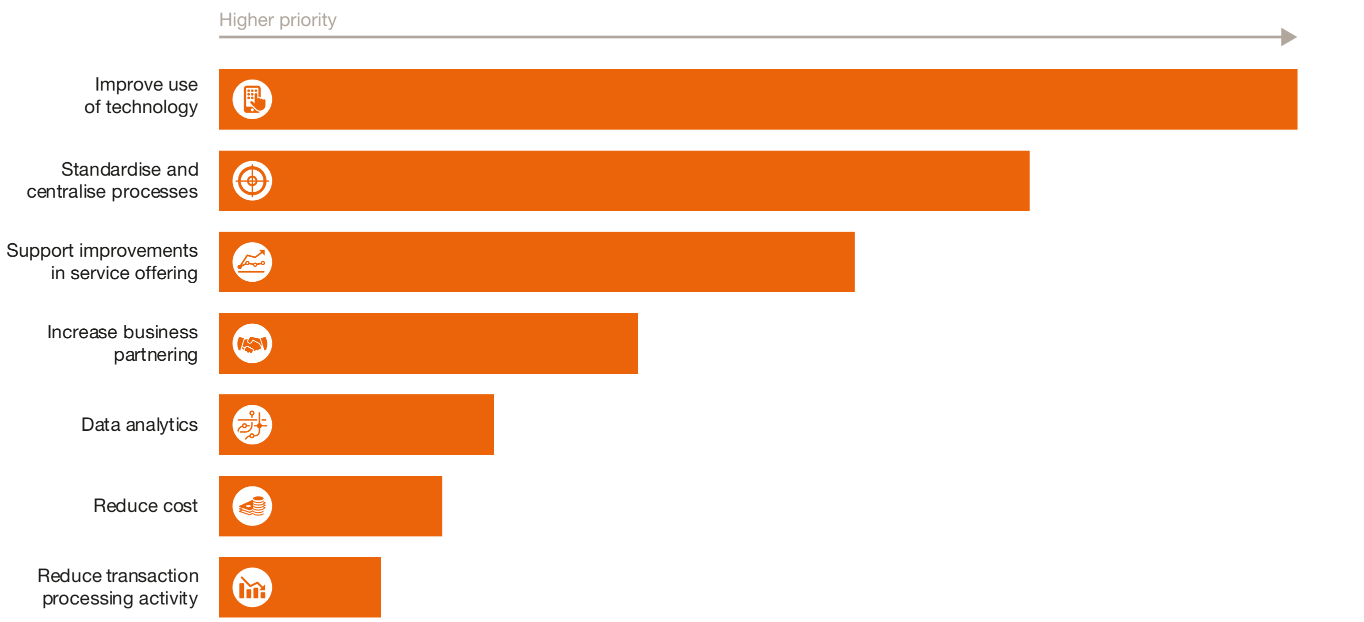
However, with historic pressure on investment, many firms are still grappling with fixing the basics. On average, only three of the eight business support functions are consistently considered a strength (Finance, Risk and HR). More than half of firms are still focused on implementing foundational technology in areas such as Time and Disbursements, Finance, HR and Risk & Compliance, with less focus on important revenue enablers such as relationship management, pricing, resource management and knowledge management systems. It's positive to note that over 70% of firms have delivered or embarked on remote and mobile working, but with work still to do to make their use a cultural norm.

In contrast to last year's survey, an increasing number of firms are viewing technology not just as a means to boost efficiency, but also as a way to re-imagine how legal services are delivered. Most firms have made progress with more traditional digital technologies like mobile apps and client collaboration tools, but adoption of more 'cutting-edge' technologies like Artificial Intelligence, Robotic Process Automation, Predictive Analytics and Smart Contracts is still immature. Unsurprisingly, the larger firms lead the way in embracing these transformational technologies.

How all firms are using/plan to use digital and emerging technologies



Top priorities for business support in the next 12 months



People

This year's survey shows firms continuing to grapple with the constant challenges of optimal resourcing and competitive remuneration. Workforce management is especially important in times of change, and the People agenda is therefore high on most board-level areas of focus.

We have seen a trend of increasing fee earner numbers (up by 5% for Top 10 and 51-100 firms, through better controlled in the Top 11-25 and 26-50 firms), offset in the Top 50 firms by a reduction in business services headcount. This suggests a focus by firms on decreasing the ratio of non-fee earners to fee earners to achieve improvements in efficiency and profitability. The survey reports a further fall in chargeable hours across all grades and bandings in the Top 50. The combination of increased UK fee earner headcount and reduced chargeable hours has inevitably contributed to an increase in spare capacity. These statistics point to the critical need for improved resource management to ensure work is performed by the right people and to facilitate re-deployment as required.

Agility will be key in wider workforce planning as firms adapt to the myriad of changes facing the sector: technology and changing client demands will impact the mix and skillset of staff required, and indeed, artificial intelligence resourcing tools may ultimately help firms to achieve optimal staffing.

A key focus for firms in a fast-changing and highly competitive environment is their strategic approach to recruiting, developing and retaining talent. Partner remuneration is a key part of that strategy, and our survey shows continued movement towards performance-related reward that increasingly draws on a basket of measures to assess performance and allocate profit. As UK firms seek to fend off competition for high performers from US firms in particular, we have seen the differential between lowest and highest paid partners stretch, with maximum multiples of 9.5 in the Top 10. Median multiples stand at 4.3 for Top 10 and 4.6 for Top 11-25 firms. These are still significantly lower than what is typical for US counterparts however.

Gender and ethnic diversity have consistently made the media headlines over the last year but the results of the survey indicate very few firms are significantly improving in this area, with the proportion of female partners still below 20% across the Top 50 firms. The most proactive firms are recognising the need to analyse their data to understand from a diversity perspective how talent flows in, through and out of the firm – this in turn should highlight where more intervention is necessary.

Surprisingly, only 20% of Top 10 and 8% of Top 11-25 firms currently intend to make changes as result of the new gender pay gap reporting requirement. Firms need to be conscious of the possible reputational impact of having a significant gap and how this will impact future recruitment, as well as influencing clients who are increasingly expecting professional advisors to have diverse and balanced teams.

Average UK headcount

	Top 10			Top 11-25			Top 26-50			Top 51-100		
	2017	2016	Change	2017	2016	Change	2017	2016	Change	2017	2016	Change
			%			%			%			%
Full equity partners	147	143	+3	78	82	-5	53	51	+4	24	24	-
Fixed-share equity	53	52	+2	61	73	-16	58	49	+18	18	22	-18
Non-equity partners	2	2	-	35	22	+59	2	11	-82	12	12	-
Total partners	**202**	**197**	**+3**	**174**	**177**	**-2**	**113**	**111**	**+2**	**54**	**58**	**-7**
>5 year pqe	254	240	+6	171	156	+10	142	128	+11	52	47	+11
3-5 year pqe	120	119	+1	87	92	-5	44	47	-6	21	22	-5
1-2 year pqe	152	142	+7	69	69	-	41	38	+8	19	20	-5
Newly qualified	63	66	-5	37	35	+6	18	20	-10	9	8	+13
Legal executives and paralegal	171	140	+22	124	116	+7	101	112	-10	45	36	+25
Trainees	139	142	-2	60	70	-14	38	35	+9	19	18	+6
Total fee earners (including partners)	**1,101**	**1,046**	+5	**722**	**715**	+1	**497**	**491**	+1	**219**	**209**	+5
Business services and secretarial support	770	791	-3	400	470	-15	287	305	-6	147	127	+16
Total	**1,871**	**1,837**	+2	**1,122**	**1,185**	-5	**784**	**796**	-2	**366**	**336**	+9

Average UK chargeable hours

	Top 10			Top 11-25		
	2017	2016	Change	2017	2016	Change
			%			%
Full equity partners	1,101	1,148	-4.1	908	974	-6.8
Fixed-share equity	1,081	1,119	-3.4	927	1,010	-8.2
Non-equity partners	-	-	-	986	1,039	-5.1
>5 year pqe	1,380	1,426	-3.2	1,195	1,245	-4.0
3-5 year pqe	1,410	1,486	-5.1	1,349	1,368	-1.4
1-2 year pqe	1,396	1,471	-5.1	1,273	1,387	-8.2
Newly qualified	1,437	1,445	-0.6	1,166	1,282	-9.0
Paralegals	933	1,119	-16.6	1,134	1,191	-4.8
Legal executives	-	-	-	986	1,258	-21.6
Trainees	1,039	1,161	-10.5	1,073	1,085	-1.1

	Top 26-50			Top 51-100		
	2017	2016	Change	2017	2016	Change
			%			%
Full equity partners	911	959	-5.0	910	872	+4.4
Fixed-share equity	940	965	-2.6	859	891	-3.6
Non-equity partners	865	919	-5.9	1,027	997	+3.0
>5 year pqe	1,155	1,184	-2.4	1,006	980	+2.7
3-5 year pqe	1,233	1,251	-1.4	1,025	1,048	-2.2
1-2 year pqe	1,227	1,286	-4.6	1,082	1,121	-3.5
Newly qualified	1,126	1,197	-5.9	973	1,076	-9.6
Paralegals	1,022	1,040	-1.7	853	879	-3.0
Legal executives	1,043	1,121	-7.0	1,032	1,034	-0.2
Trainees	934	956	-2.3	729	815	-10.6

Financing

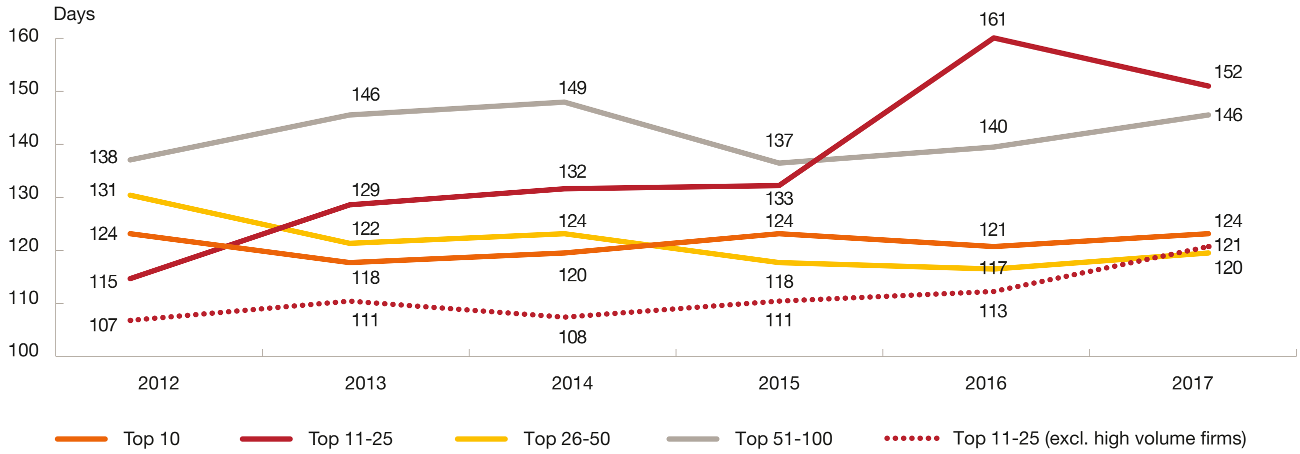
Despite a number of recent high profile failures in the legal sector, external funding apparently continues to be readily available to law firms and for the first time in our survey, represents, on average, at least 19% of firms' funding across all bands. Taking partner personal capital loans into account too, the level of external bank funding is closer to 60% on average across the bandings.

There is no guarantee however that the funding environment will continue to be so benign, and with competition high and profitability under pressure, firms are well advised to build some caution into their cash flow forecasting. Freeing up cash through better working capital management remains challenging across the sector, with lock-up days having deteriorated across all bandings in both the UK and internationally, and now typically exceeding four months even at year end. Whilst we see scope for significant improvement, this will be dependent on cultural and behavioural change, improved processes and management information, and clear lines of responsibility and accountability – not an easy dial to shift!

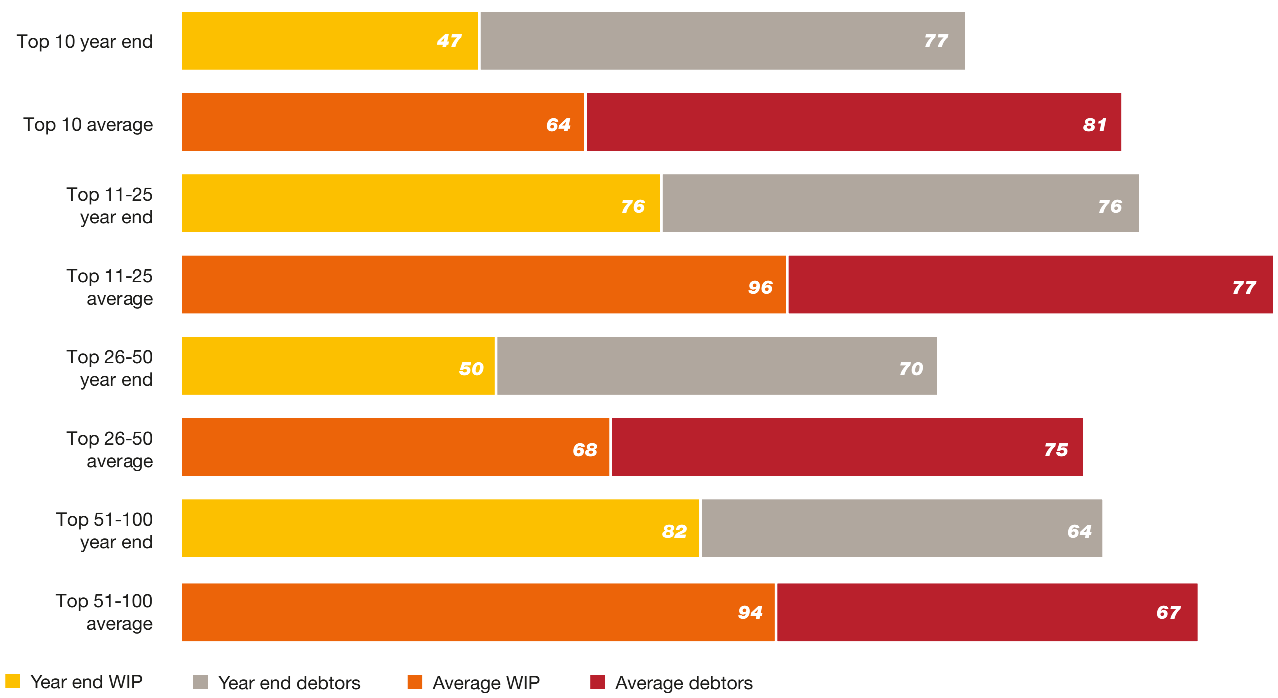
Meanwhile, the requirement for capital has probably never been greater. Factors including staff cost inflation, the need to remunerate partners and staff commensurately with US rivals to retain the best talent, and the imperative to invest in technology and IT security, all demand funds.

What is clear from this year's survey is that firms are delaying distributions, with partner current account balances increasing for the majority of firms. Top 10 firms, for example, have reduced the amount paid out in the year in which profit is made from 60% to 55%. We have yet to see evidence of law firms moving away from the full distribution model but, for those firms looking to future proof themselves in a changing world and protect the firm's legacy for future generations of partners, that may become the only option to generate sufficient cash for reinvestment in the partnership.

Trend in average UK year end total lock-up days



UK year end and average WIP and debtors days



Average proportion of year end financing provided by the following elements

	Top 10		Top 11-25		Top 26-50		Top 51-100	
	2017	2016	2017	2016	2017	2016	2017	2016
	%	%	%	%	%	%	%	%
Partner fixed capital and current accounts	79	86	79	72	73	75	78	75
Direct external funding	20	13	19	20	22	20	21	19
Other	1	1	2	8	5	5	1	6
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

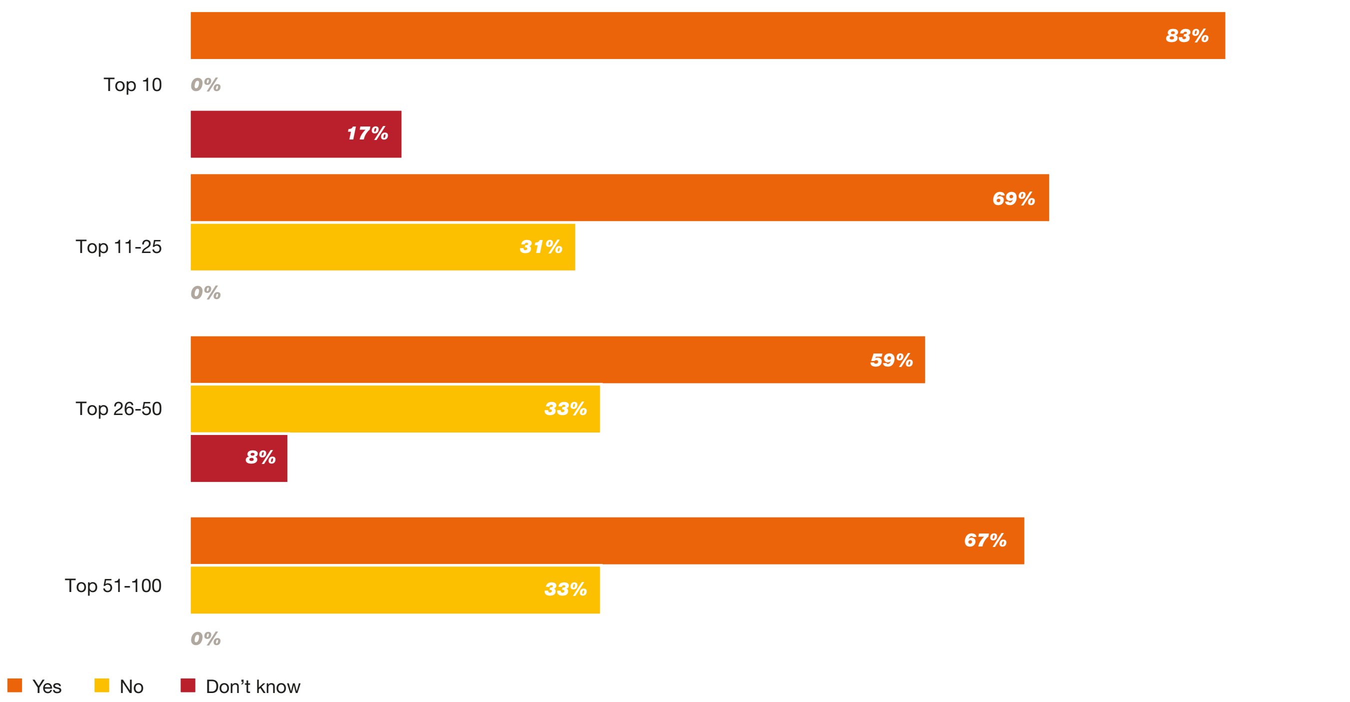
Risk

There have been a number of high profile incidents in the past year whereby organisations, including law firms, have been the victims of global ransomware attacks. These have highlighted the increasing threat posed to law firms and the importance of having sufficient information security defences.

In addition to adequate defences, there is a need for detailed, robust and well-tested business continuity plans ("BCP") and crisis management procedures to ensure that if an attack penetrates the firm's defences, the organisation is able to respond appropriately, contain the event and return to full operations as quickly as possible. Our survey has revealed that more work is needed in this area, with 16% of firms having no business resilience framework and a further 25% failing to test BCPs annually.

A new regulation applicable from May 2018 is General Data Protection Regulation ("GDPR") which will impose a much tougher regulatory environment over the processing of personal data. Although firms have progressed over the past 12 months in terms of performing readiness assessments, we are seeing a high level of uncertainty as to how managing data in a GDPR regime will work in practice.

Percentage of firms that have suffered from security incidents over the last year



The law firm of the future

Introduction

This year's survey shows that the need for change is accelerating. The key question then is how should law firms adapt to the rapidly changing landscape – what will the successful law firm of the future look like?

As in any client service business, the winners of the future will be those who best respond to the changing needs of clients. Clients have long been frustrated with the cost of legal full service delivery and many have responded by taking more work in-house, supplemented by bringing individual lawyers in through 'lawyer on demand' providers. Their watchword is efficiency. At the same time, they want an integrated global service with simpler and more digestible output, providers with deeper understanding of their clients business and processes to which in-house teams can actively contribute. Whilst clients are still willing to pay a premium for the best advice, they want to know that their providers are making full use of available technology so that they are not paying for expensive resources to undertake repetitive work manually.

What may have seemed like a wish list of irreconcilable demands now feels in reach due to the development of new technologies and tools, and the entry of new players who are willing to use them. The liberalisation of the legal market has led to the emergence of new players in legal services. These organisations are meeting with growing success due to their efficient, lower cost models which include making far greater use of technology than traditional law firms. The new entrants have space to grow as many traditional law firms have been unresponsive to changing demand.

At a time when supply already significantly outstrips demand, firms who cannot keep up with this pace of client led change may eventually disappear.

Large traditional law firms, on the other hand, have powerful strategic advantages over new entrants: strong, trusted brands; well established international networks; long standing client relationships; and exceptionally talented and highly trained people. Large law firms also have a latent critical advantage which they are yet to exploit – a goldmine of data on each of their longstanding clients. Law firms which choose to innovate in order to respond to the needs of clients whilst capitalising on their strategic advantages will come to dominate a smaller number of true global players.

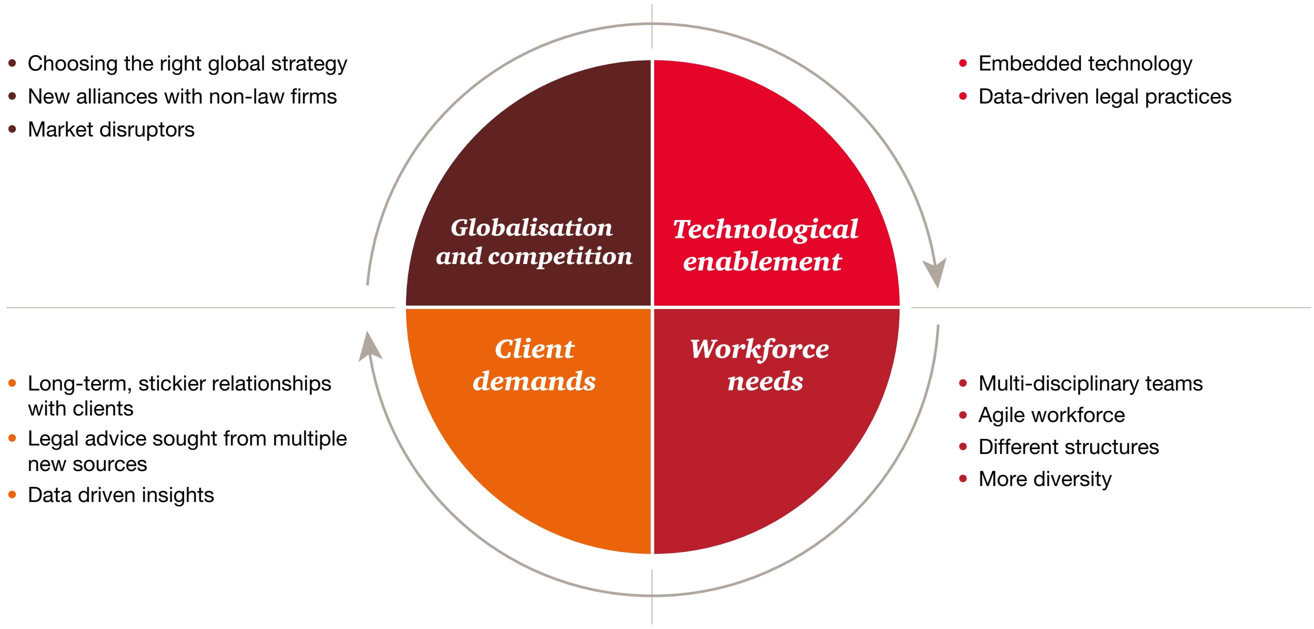
Different legal disciplines will be impacted differently by technological advances. Technology, process re-engineering and intense competition will radically change how 'business as usual' legal work is done. The willingness of clients to use alternative service providers and take more work in-house will drive a fundamental shift in efficiency and continue to drive down price for this type of work. On the other hand, highly complex, bespoke and risky areas, such as M&A and litigation will continue to be the domain of premium law firms.

These dynamics will drive a growing disparity between premium work and non-premium work which in turn will create increasing tension in the single business partnership model. The premium law firms of today will face a critical strategic choice – either to focus solely on the premium work and effectively withdraw from areas where their business model is unsustainable ***or*** to embrace new business models where 'business as usual' legal services are delivered very differently.

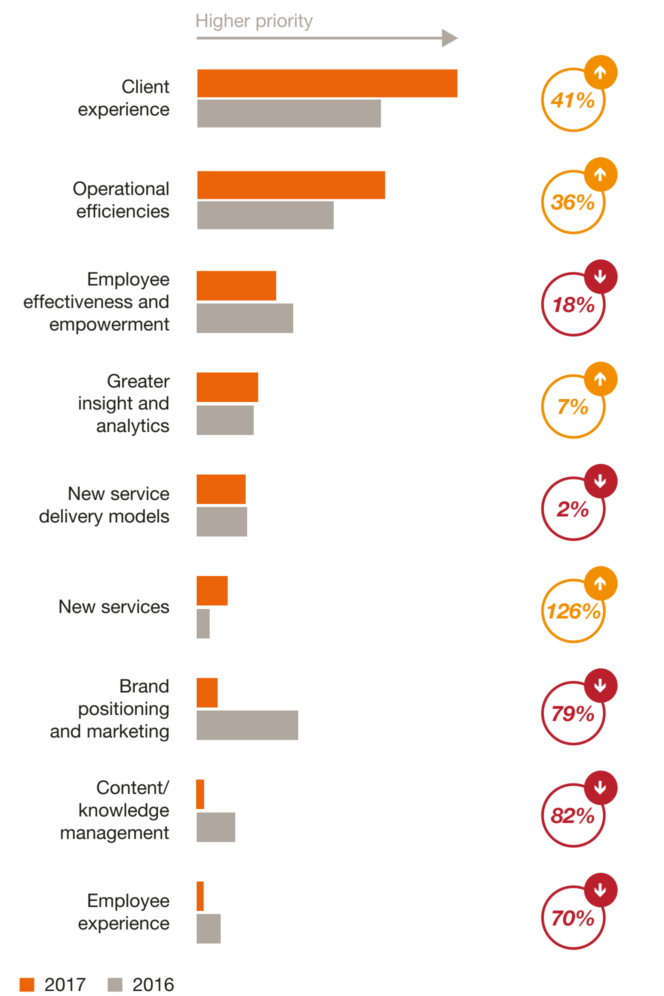
Most law firms recognise the challenge – over half of Top 25 law firms are 'somewhat concerned' about new entrants. The use of emerging technologies is growing – 80% of Top 10 firms and 57% of Top 11-25 firms have already established or begun piloting Artificial Intelligence solutions. Perhaps not surprisingly, the Top 11-25 and 26-50 firms lead the way with Robotic Process Automation (RPA) with one third piloting or having already established this technology.

'Client Experience' and 'Operational Efficiencies' were the most important drivers for emerging technology use, but 'New Services' had the greatest year-on-year gains. However, the journey has only just begun and more fundamental market change is on the horizon.

What will the law firm of the future look like?



Drivers for the use of digital and emerging technologies



Globalisation and competition

International clients demand an integrated international service. One of the greatest challenges for law firms is to determine what the best global strategy is for their firm in order to meet this demand.

Determining which geographic markets are worthy of new investment and which established markets should continue to be supported/invested in is a strategic priority for all. Along with this, comes the decision as to whether to adopt a global 'one firm' partnership approach, a networked 'verein' strategy or 'best friends' relationships. Many firms are turning to blended solutions, dependent upon the regulatory complexities of the geography or their appetite for risk that comes with full merger.

In the future, we believe new alliances will also be forged with technology providers and low cost service providers to offer full service solutions to client problems. Law firms will also bring in other professional disciplines to support their overall offering; for example, consulting, forensics, risk – directly competing with a wider set of professional services players.

The full service law firm of the future will be more diverse in terms of business model. Different areas of the business will look quite different in terms of the leverage model, career path, team composition, pricing and partner income. Innovative firms will think not only about making current offerings more efficient, but how technology can allow them to develop new services that incorporate their expertise in a different way.

Much has been made of the impact of US law firms in the UK legal market. Over the last few years some US law firms have gone about significantly growing their UK practices, judiciously head-hunting both established senior partners and ambitious young rainmakers from UK firms.

These hires, coupled with leveraging the strength of their US business relationships (and in particular, US Private Equity houses), means these firms now represent formidable competition and are undoubtedly 'here to stay'. In addition to taking market share, their ability to pay partners without lock step restrictions and fee earner salaries a step beyond UK firms, means that traditional partner remuneration and staffing models are also being heavily disrupted.

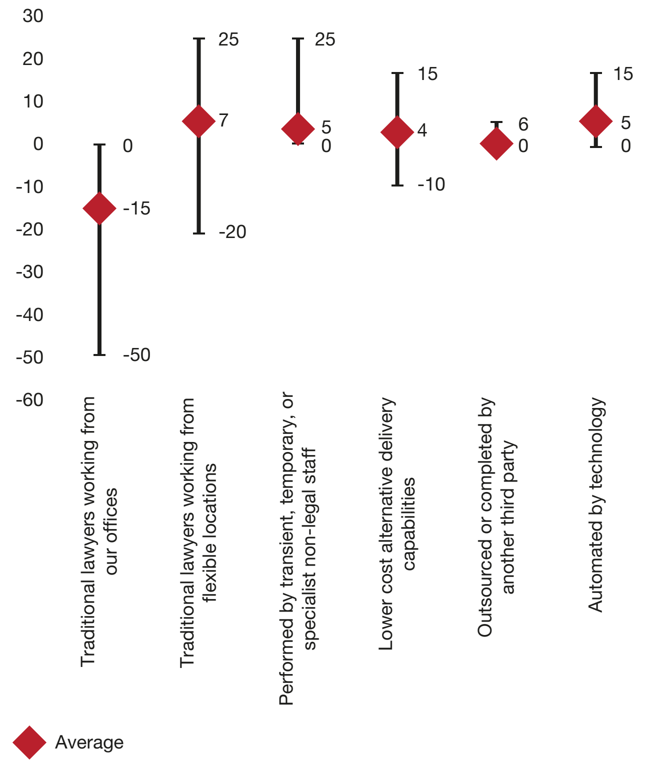
Elsewhere in our survey, we see that UK firms consider US law firms as the most likely types of merger partner. The fact that many US law firms are already well established in the UK and generally performing well ahead of UK firms in terms of profitability, makes major full UK to US mergers unlikely in our view. More likely will be network/best friend arrangements with US firms still seeking better access to the UK market.

Before we leave the subject of competition, we should address the question of what effect the 'big four' Accounting Firms are likely to have in the future.

The traditional lines between Accounting and Legal professional service providers are becoming increasingly blurred. Areas such as data privacy, cyber crime, employment law and pensions are now commonly served by both law and accounting firms. Accounting firms are also investing heavily in managed legal services and utilising technology to provide services such as contract automation. Equally, law firms are increasingly competing in areas traditionally dominated by accounting firms such as tax advice and forensic services, so it is by no means a one way street.

In a market already saturated with legal service providers, the accounting firms' most likely successes will be in complementary areas to existing services (e.g. tax) and managed legal services, where their financial resources and ability to build scalable technological solutions is arguably greater than traditional law firms.

Range of change in how law firms estimate work to be delivered between 2020 and 2025



Technology enablement

Embedded technology

The larger firms of the future will have embedded best in class technology into all of their legal processes, and will continuously innovate as better software tools are developed. Work will still be led by people but they will be augmented by technology, including Artificial Intelligence – taking many manual hours out of processes and allowing risk management coverage that is unfeasible today. Output from service providers will look very different – more visual and frequently interactive.

Data-driven legal practice

Successful law firms will have command over their unstructured data and this will enable them to develop a meaningful understanding of their clients' businesses and their legal risks. Decisions and actions will be driven by data rather than by experience. Law firms will have their own predictive analytics for their clients, trained through case history. This will favour firms with the deepest experience and will discourage clients from switching advisors.

Workforce needs

Multi-disciplinary teams

The new way of delivering legal services will depend on a range of professionals, not only lawyers. New specialisms will emerge – legal project managers, legal process designers, law technologists and law data scientists. Law firms will develop rewarding career paths for these people in order to attract and retain them. Sales teams will also professionalise, helping navigate the procurement process. Distinctions between 'fee earners' and 'non-fee earners', 'lawyers' and 'non-lawyers', 'permanent employees' and 'contractors' will blur.

Agile workforce

Alternative service providers and in-house teams have benefitted from the pool of talented lawyers trained by law firms who are seeking a different work-life balance. Retired lawyers can also be considered a deep pool of untapped potential. The law firm of the future will offer different career/work options so that it can retain access to the best talent while benefitting from a more flexible staffing model.

A different structure

Law firms of the future will not be restricted to the partnership model, which we have already said does not necessarily facilitate future investment. Rather, they could be multi-disciplinary partnerships, public companies, financial investor-backed private companies, or blended hybrid structures. The transformation required to thrive in the new order will be costly and firms will look to alternative sources of funding to pay for it. Furthermore, 'non-lawyers' will play an increasingly important role in future law and different structures will better facilitate more equal reward.

Client demands

Clients will work with fewer law firms globally and relationships will be long-term and deeply embedded. Clients will put firms through challenging procurement processes before selecting them for their global legal panels or for exclusive provider status for certain areas of legal service. Engagements between law firms and clients for 'business as usual' law will look more like outsourcing contracts – designed to meet long-term needs. Data will flow seamlessly between advisor and client and the client will have shared access to tools. Set up costs will be higher and the relationships will be 'stickier', with higher barriers to switching by clients.

Law firms will have analytical insight across the breadth of their clients' activities which will make them more valuable to clients and extend relationships beyond the legal department.

1 Global financial performance

At a glance

Overall

- Global Top 10 firms have achieved fee income and profit growth of 8.1% and 9.8% respectively. The Top 11-50 growth is 7.1% and 6.8%. Whilst both UK and international operations have delivered some underlying growth, foreign exchange has been a major contributor to the increase.
- In Top 10 firms, before the impact of exchange, fee income and profit have grown by 3.1% and 5.2% respectively, whilst for Top 11-50 firms pre FX, fee income grew 3.8% and profit 3.9%.

Movements in foreign exchange rates

- Movements in foreign exchange rates have had a significant impact on growth of global fee income and profits. For Top 10 firms, foreign exchange movements contributed almost two-thirds of the overall fee income growth and almost half of overall profit growth.
- In Top 10 firms, global fee income is 4.9% higher due to movements in foreign exchange, and for Top 11-50 firms 3.2% higher. At the profit level, the message is similar, with a 4.4% and 2.8% benefit to Top 10 and 11-50 firms respectively.
- The overall average monetary impact on revenue and profit is £43.7m and £16.2m in Top 10 firms, and £6.3m and £1.9m in Top 11-50 firms, equating to a profit per all partners of £33k in Top 10 firms and £9k in Top 11-50 firms.

Global headcount

- Global headcount is broadly consistent with 2016 for Top 10 firms, with a fall of just 0.1% to 4,211. Top 11-50 firms have increased total headcount by 8% on a like for like basis, adjusting for mix of firms (without this adjustment our survey is showing a 26.8% increase to an average of 1,283).

Global profits

- Whilst movements in exchange rates have benefitted global profitability, this has been accompanied by an improved underlying performance by international offices. In Top 10 firms they delivered an average of £11.9m to the profit growth, which accounts for 35% of the year on year increase, over half that derived from the UK.
- Global profit margins have deteriorated slightly in Top 10 firms from 38.7% to 38.3%, resulting from improved international profitability offset by a fall in the UK margin. Top 11-50 firms have closed the gap on their larger rivals, with a margin movement from 30.0% to 33.3%, an improvement driven by better performance in both the UK and international territories.

International analysis

- Although the survey reports improved international profits, net profit margins continue to lag behind UK. For Top 10 firms the average UK margin of 37% compares to average margins from -1% in Africa to 33% in Western Europe and Australia.
- The variation in performance by firms within bandings continues to be significant. For example, net profit margins for Top 10 firms in China range from -28% to 47% (Top 11-25: -12% to 29%) and in Middle East from -25% to 40% (Top 11-25: -68% to 22%).
- Top 10 chargeable hours for 1-5 years pqe has fallen in the majority of regions; the only regions improving chargeable hours are USA and Australia. Similarly, Top 11-25 firms have seen only one region improve 1-5 years pqe chargeable hours (Middle East).
- Average fee rates per hour in Top 10 firms range from £198 in Africa to £409 in USA, compared to a UK average rate of £297. The range is less significant in Top 11-25 firms: £221k in Western Europe to £287 in the Middle East (UK - £256). In Top 26-50 firms, average rate per hour in international offices ranges from £215 in Western Europe to £271 in the Middle East, with UK performance lagging at £210.

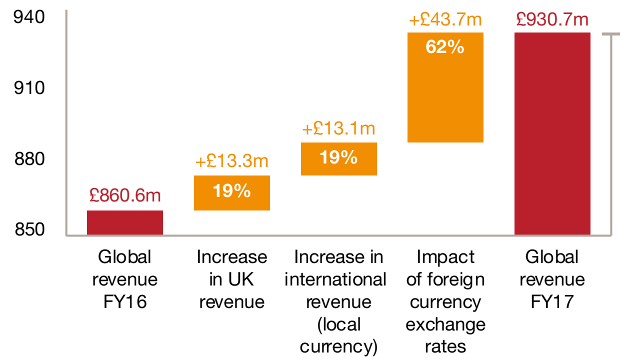
UK top tier vs US top tier

- US top tier firms continue to significantly outperform the UK top tier in respect of all key performance indicators; for example, US top tier firms achieve an average PEP of £1,939k which is 58% ahead of the UK top tier performance (£1,227k).
- Across the ‘per partner’ and ‘per fee earner’ key performance indicators, the US to UK top tier performance gap ranges from 30.7% for fees per full equity partner to 98.1% for profit per fee earner, with the net profit margin performance gap being 4.4 percentage points (US: 45.9%, UK: 41.5%).

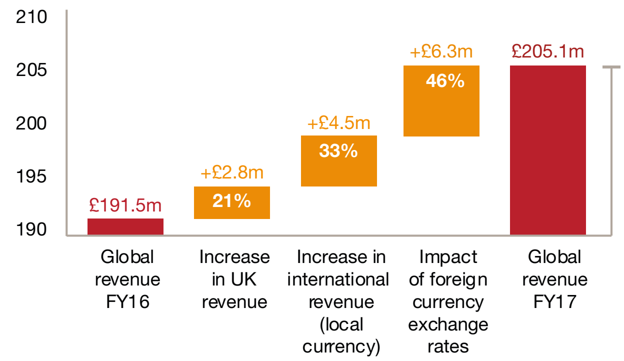
Global fee income and profits: underlying growth vs foreign exchange movement

The movement in foreign exchange rates has had a significant impact on the global revenue and profits of UK based global law firms.

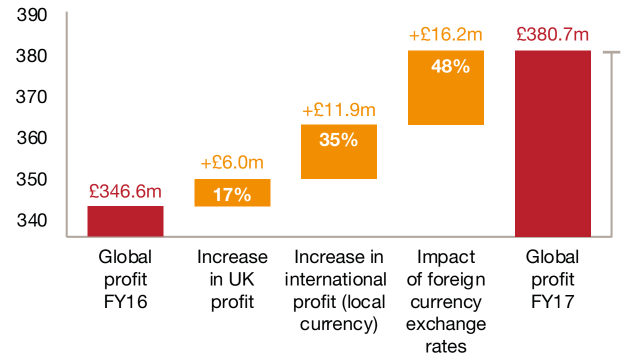
Top 10 – Revenue



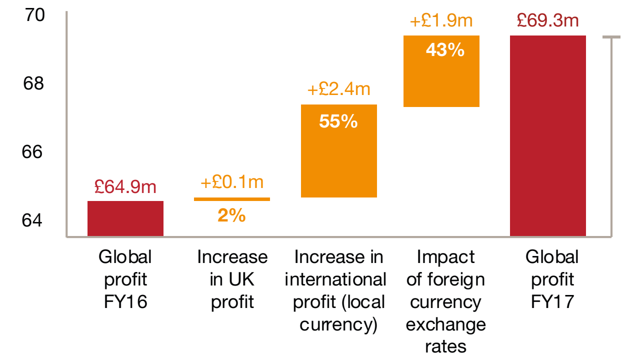
Top 11-50 – Revenue



Top 10 – Profit



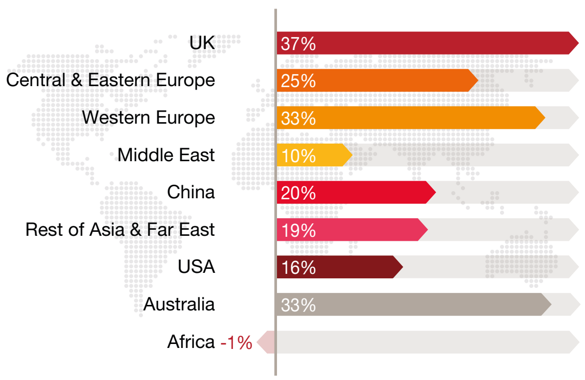
Top 11-50 – Profit



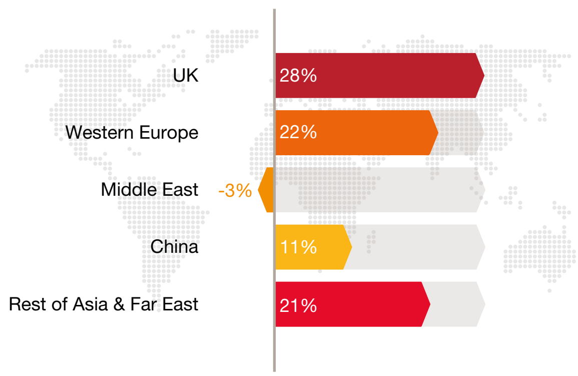
Net profit margin: UK vs international regions

International regions continue to dilute the net profit margins achieved by UK firms.

Average profit margin by region (Top 10 firms)



Average profit margin by region (Top 11-25 firms)



2 UK financial performance

At a glance

Fees

- Whilst at least 70% of UK firms across each of the Top 100 bandings recorded increases in fee income in the current year, fee income growth has been limited – average growth in Top 10 and 11-25 firms is 2.5% and 2.3% respectively (2016: 4.4% and 2.9%). For Top 26-50 firms, average UK fee income growth was 3.7% (2016: 4.1%).
- The proportion of total fee income delivered from fixed fees continues to grow with 25% (2016: 21%) and 27% (2016: 25%) of UK fee income in Top 10 and 11-25 firms being delivered on this basis.
- Fees per chargeable hour have increased across the Top 10, 11-25 and 26-50 bandings by between 3.4% and 7.6% on average; although, this is likely driven by reduced chargeable hours per fee earner.
- Fees per fee earner have seen little movement since last year: Top 10: £380k (2016: £378k); Top 11-25: £290k (2016; £289k); Top 26-50: £216k (2016: £208k); Top 51-100 on a like for like basis: £169k (2016: £168k). It is noticeable that, in certain firms, fees per fee earner has only held up on the basis of reduced headcount.

Staff costs

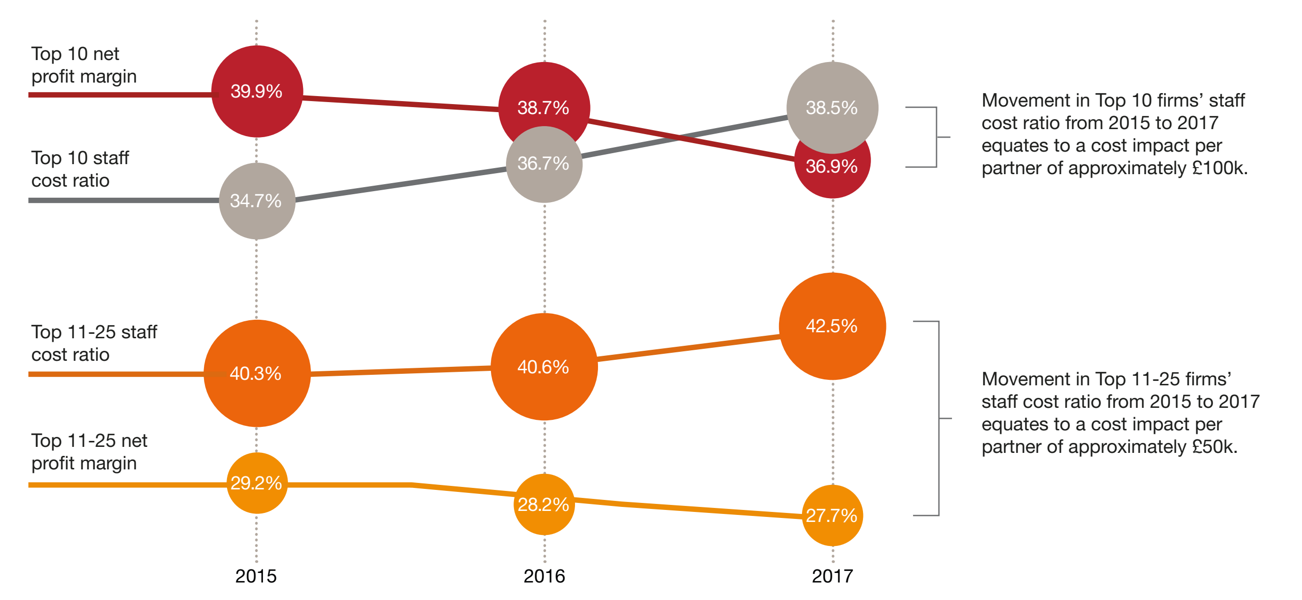
- There has been an increase in the staff cost ratio across the bandings. The Top 10 increase in the staff cost ratio of 1.8 percentage points to 38.5% impacted margins and reduced profits by, on average, £6.9m per firm. The impact in Top 11-25 firms was £3.3m, with the staff cost ratio rising from 40.6% to 42.5%.
- Fee earner cost per chargeable hour across all the Top 50 bandings has increased: Top 10 firms by 6.7% to £95 per hour; Top 11-25 firms by 8.0% to £94 per hour and Top 26-50 firms on a like for like basis by 2.1% to £80 per hour.

Profits

- One quarter of firms in our survey reported a reduction in both fee income and profits, whilst close to half of all firms recorded falling profits.
- Top 10 firms' profit margins continue to fall, from an 8 year high of 40.0% in 2014 to 36.9% in 2017. Top 11-25 firms' average margin also fell from 2016 by 0.5 percentage points to 27.7% in 2017. Top 26-50 and 51-100 firms managed to maintain margins, reporting increases in net profit margins of 0.2 (on a like for like basis) and 0.6 percentage points respectively.
- Top 10 firms' average PEP fell by 2.3% to £1,043k, with equity partner headcount up just 2.8% to 147. Top 11-25 firms minimised the impact of margin erosion on PEP through ongoing partner headcount management (down 4.9% in 2017), with average PEP growing to £647k (5.4% increase).

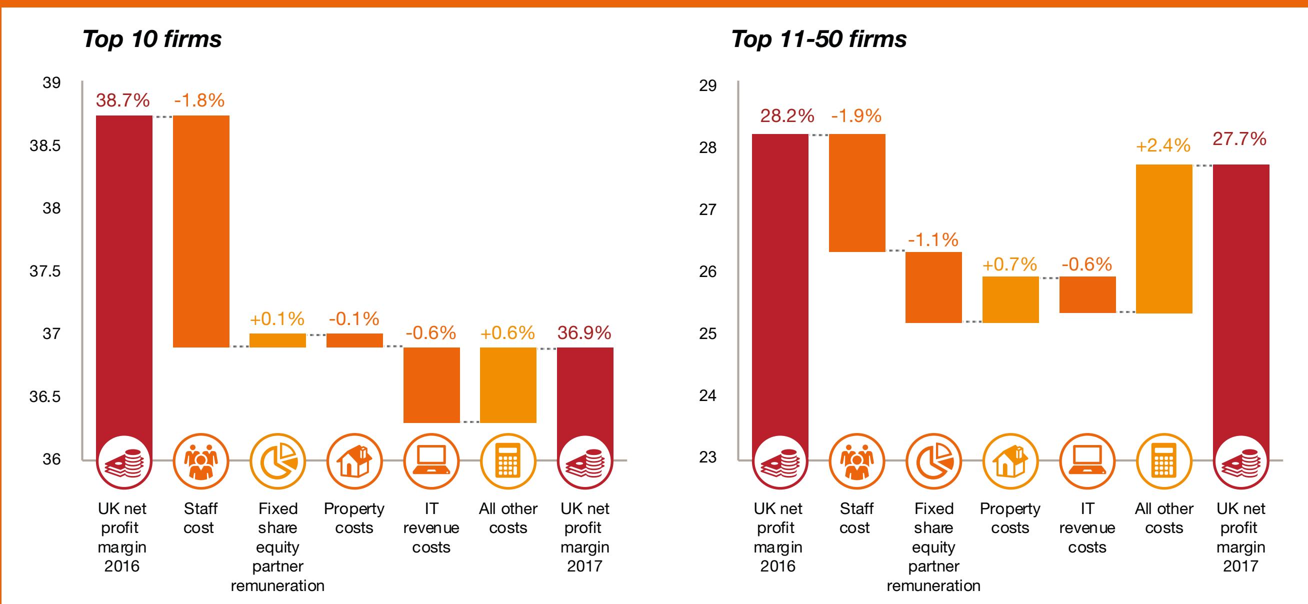
Movement in net profit margin and staff cost ratio: 2015 to 2017

The increasing level of staff costs is clearly impacting the net profit margin of UK law firms.



Net profit margin bridge: FY16 to FY17

There is a clear impact of increasing costs, in particular staff costs, on UK net profit margins.



3 Business support

At a glance

Overall

- Finance, HR and Risk & Compliance continue to be considered the strongest performing functions in 2017, although HR is less likely to be viewed as a strength compared to previous years.
- The top two priorities for the business support functions remain improving the use of technology and standardising and centralising processes. We still view these areas as basic housekeeping, but it is encouraging to note two new responses – 'support improvements in service offering' and 'data analytics' – being identified as important, with the former being a new third priority.
- Employing and utilising business services specialists is key to improving business support. The survey identified that Top 10 firms now have capabilities in all key areas, with all firms having pricing specialists. 'Data and analytics' and 'digital and emerging technologies' are identified as important new areas, with 47% and 41% of Top 100 firms having specialists in these areas. Despite the presence of specialists, the absolute numbers remain small relative to fee earners; for example, there is on average only four pricing specialists in Top 10 firms.

Finance

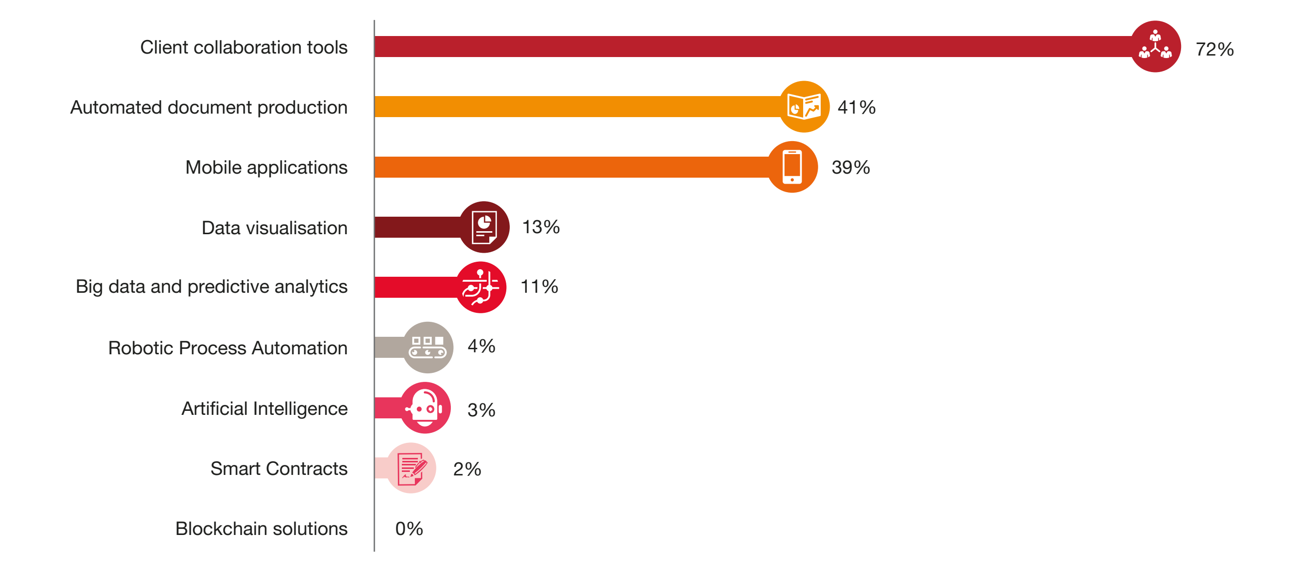
- The Finance function's priorities are business analysis/reporting, pricing and profitability, and process efficiency, which is consistent with previous years. While accuracy, breadth and granularity of reporting (MI) is considered broadly satisfactory, 'accessibility' and 'the responsiveness of the firm to insights provided' remain key challenges for Finance.
- As reported in previous years, work in progress write-offs remain a key challenge for all firms. Assuming the level of write-offs to be at the median of the reported range, UK write-offs on average were: £61m for Top 10 firms, £21m for Top 11-25, £12m for Top 26-50, and £5m for Top 51-100. The survey revealed 'not billing for changes in scope' and 'inaccurate estimates' to be the most common causes.

Technology

- IT functions have received mixed scores in terms of effectiveness. The focus of most IT functions continues to be getting the basics in place. More than half of firms are still focused on planning or delivering systems to support Time and Disbursements, Finance, HR, or Risk & Compliance. Mobile and remote working has been a big focus with over 70% of firms already having delivered or embarked on such projects.
- Top 10 firms are starting to lead the adoption of digital and emerging technologies. Increasingly, firms appear to recognise the role these technologies can play, with 'client experience', 'operational efficiencies', and 'new services' being the drivers for adoption with the largest gains since 2016. For smaller firms with less capital to invest, identifying the right opportunities to pursue poses a particular challenge. Firms outside the Top 25 will have to be highly selective when identifying emerging technologies that align with their service offering and therefore support their broader strategic objectives.
- While most Top 100 firms are progressing with mobile apps and client collaboration tools, there is a marked difference in maturity between these more conventional technologies and the more nascent technology, such as Smart Contracts and Blockchain Solutions. 80% of Top 10 firms have begun piloting or have already established AI. Top 11-25 and 26-50 bands lead the way with Robotic Process Automation (RPA) with one third piloting or having already established this technology.

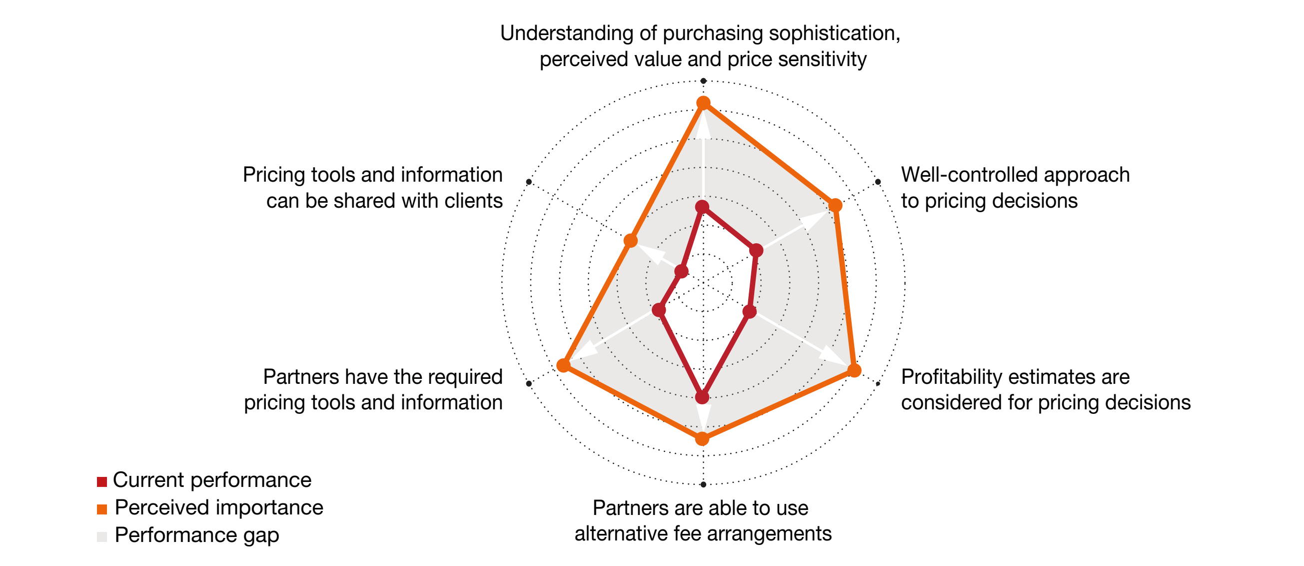
Has your firm established the following digital and emerging technologies? – All firms

Law firms have generally adopted the more commonplace technologies, whilst the uptake on innovative technologies is yet to take off.



Pricing practices: current performance vs importance

There is a significant difference between the importance of pricing capabilities and the current performance of law firms in those respective areas.



4 People

At a glance

Headcount

- The average movement in UK fee earner headcount has varied with increases in the Top 10 and 51-100 firms (both 5%) and Top 11-25 and 26-50 firms (both 1%).
- On the other hand, the survey results show that the average number of full time equivalent staff in business support has fallen across all of the Top 50, by 3% in the Top 10, 1% (on a like for like basis) in the Top 11-25, and 6% in the Top 26-50.
- The 5 year pqe grade comprises the largest category of staff in firms and has grown across all bandings (Top 10: 6%; Top 11-25: 10% ; Top 26-50: 11% ; Top 51-100: 11%). This suggests a potential bottleneck of talent at this grade as firms closely control the numbers promoted to partner. This issue is compounded by the fact that average chargeable hours at this grade have declined by 3.2% in the Top 10, 4.0% in the Top 11-25 and 2.4% in the Top 26-50.
- Trainee headcount for the Top 10 and 11-25 fell by 2% and 14% respectively; however, the latter movement is due to mix of firms and on a like for like basis trainee headcount remained consistent. With the increasing reliance on technology and firms utilising alternative approaches to delivery of work we may see further reductions in trainees and other junior grades. This may, in time, alter the profile of fee earner headcount in law firms.

Chargeable hours

- Following the decline in utilisation in 2016, UK chargeable hours continued to weaken in 2017 with a further drop in average chargeable hours across all grades and bandings in the Top 50 firms. For the >5 year pqe grade in the Top 10 and Top 11-25 the average chargeable hours was 1,380 (fall of 3%) and 1,195 hours (fall of 4%). This drop in average chargeable hours is mirrored internationally in Western Europe, USA and Asia and the Far East.
- Overall, average spare capacity (i.e. the excess headcount) across all fee earner grades for Top 50 firms has increased. In the Top 10 this has increased marginally from 13% to 14%. For Top 11-25 and Top 26-50 this increase is more pronounced with an increase from 13% to 17% and 12% to 16% respectively.

Leverage and cost

- In terms of leverage, the ratio of fee earners to secretaries has increased across all bands. The ratio of fees earners to full equity partners has increased for the Top 10 (6.5 to 6.7) and Top 11-25 (7.2 to 7.7). It has fallen slightly for the Top 26-50 (9.3 to 8.3).
- Costs per fee earner have increased for the Top 10 (3%) and Top 11-25 (4%), reflecting the competitive environment for attracting and retaining talent. In the Top 26-50 firms, the cost per fee earner has fallen by 2%.

Partner remuneration models

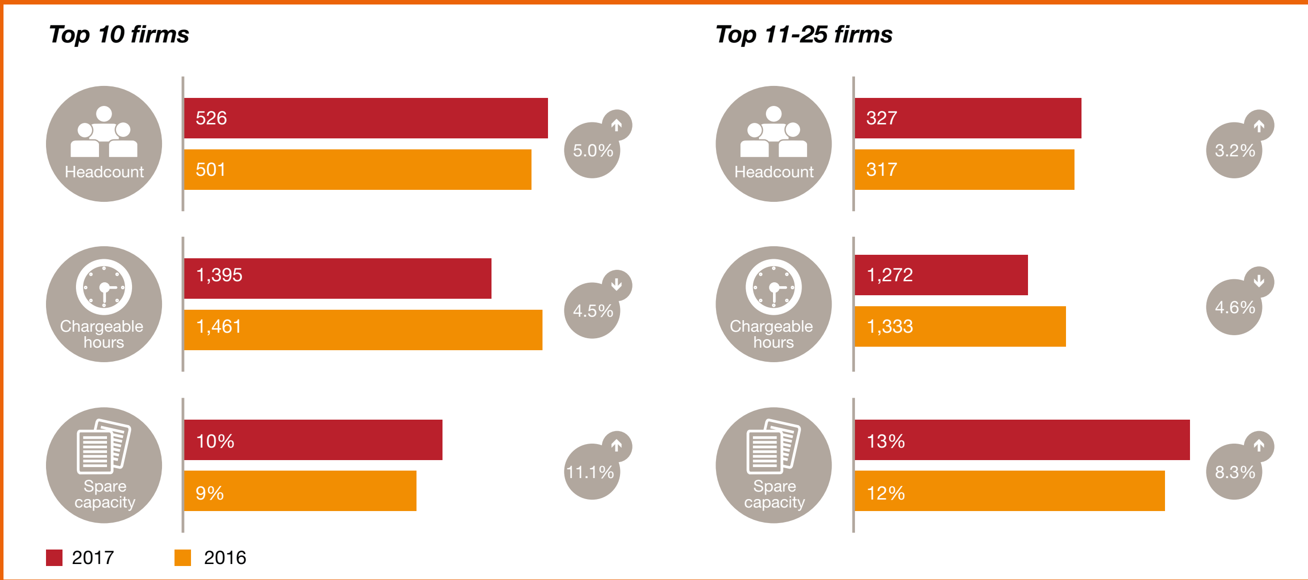
- In terms of reward, the movement towards performance-related partner reward structures continues and the survey shows that fee income, profitability, chargeable hours and referral of work are key metrics which impact on partner remuneration.
- There is a large variance in terms of profits allocated to newly promoted full equity partners within law firm bands: the ratio from highest to lowest is 5.4:1 in Top 10 firms and 6.5:1 in Top 11-25 firms. However, the equity partner pay differential (i.e. profit allocated to highest paid partner as a multiple of a newly promoted partner's allocation) is relatively narrow with the median multiple ranging from 2.3 – 4.6 across the Top 50 firms.

Diversity

- Firms continue to recruit a greater proportion of female trainees than male but this proportion falls steeply at partner level where the female proportion is 18% in Top 10 firms and 19% in Top 11-25 firm.
- The majority of firms have yet to respond to the new Gender Pay legislation introduced in April. 80% of Top 10 firms and 92% of Top 11-25 firms stated that they have no actions planned in response to this legislation. Top 26-50 firms have shown a more active approach with 36% of firms having some form of action planned or having already taken action. Of those actions, the most common are changes to reward structures, recruitment and development of staff.
- In other sectors the diversity debate is broadening out more widely than gender, with BAME (Black, Asian and Minority Ethnic), for example, demanding more focus. We expect the legal sector to apply greater focus to a wider spectrum of diversity challenges in the future.

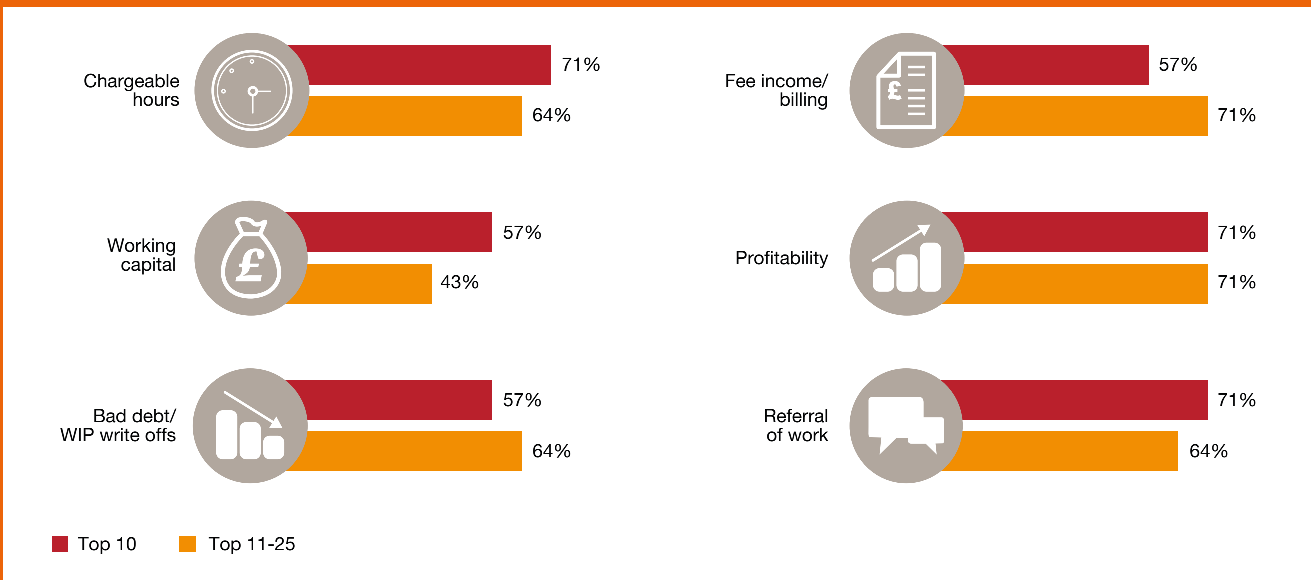
Movement on headcount, chargeable hours and spare capacity (1 - >5 years pqe grade)

The increase in headcount is having a detrimental impact on chargeable hours per member of staff, resulting in increased spare capacity.



Partner performance metrics

The most common metrics that impact partner performance are chargeable hours, fee income/billing, profitability and referral of work.



5 Financing

At a glance

Lock-up

- Lock-up performance has deteriorated across all bandings both in the UK and internationally, and typically now exceeds four months. Year end lock-up in 2017 across the bandings varied between 120 and 152 days.
- There continue to be significant opportunities for firms to improve their 'matter-to-cash' performance and firms could generate significant additional cash to reduce their dependence on external debt. For example, on average a Top 10 firm could generate £14.2m by achieving a 110 lock up day benchmark. Further, cash benefits would be realised by firms improving year round billing and cash collection disciplines, as there remains a significant gap between average and year end lock-up (between 15 and 23 days across all bandings).
- 55% of firms identified a lack of cash culture and the absence of appropriate sanctions as the key reasons behind poor lock-up performance. Whilst there has been an increase in sanctions applied to equity partners across all bands (with the exception of Top 10 firms) this does not appear to have led to improved lock-up performance and we question whether the sanctions applied have 'teeth' to encourage improved behaviours.

Funding

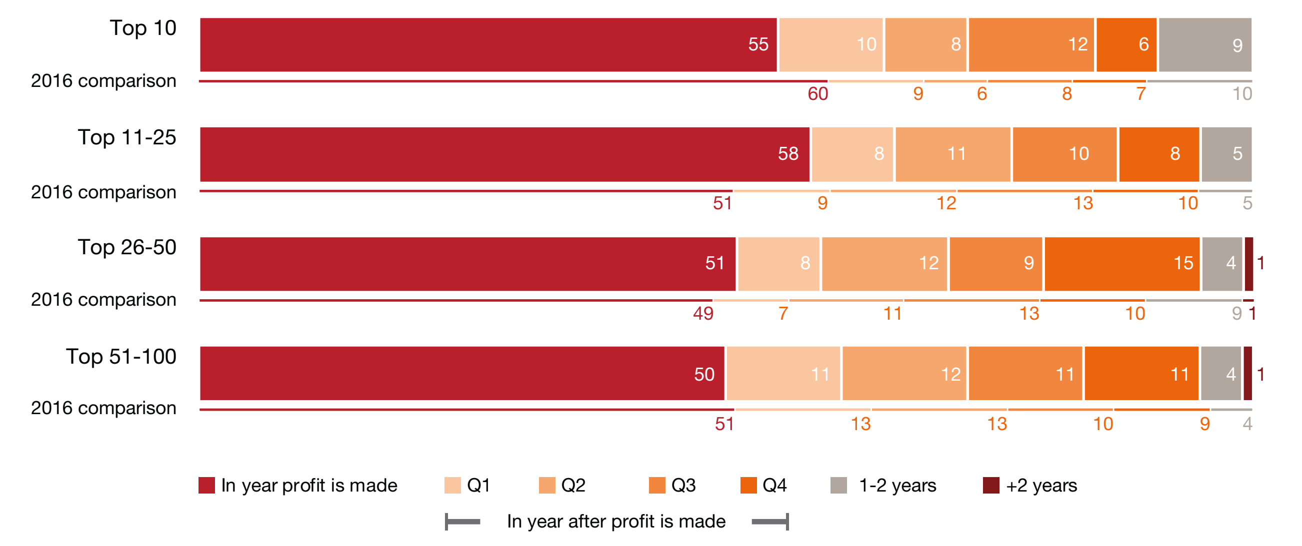
- External funding appears to be readily available to law firms with minimal (if any) additional renewal cost; for example, 78% of Top 10 firms reported facility renegotiations in 2017 (compared with 43% in 2016) at no increase in interest cost. External funding now represents approximately 20% of all firms' funding across all bands.
- Banks also provide a significant proportion of lending to partners to fund capital contributions; for example, 90% of partner capital funding for Top 10 partners is provided by the firm's bankers. The real level of external funding is, therefore, closer to 60% on average across all bandings.
- Full equity partner current account balances have increased across all bandings, driven by delays in distributing profits. Top 10 firms have reduced the amount paid out in the year in which the profit is made from 60% in 2016 to 55% in 2017. The average level of current account balances across the bandings in our survey varies between £258k in Top 51-100 firms to £547k in Top 10 firms.
- Building stronger partner funding balances will assist firms through the working capital cycle. Average total UK partner funding, that is both capital and current account, is £884k in Top 10 firms, falling to £440k in Top 51-100 firms.

Investment

- As firms continue to evolve and innovate, many are considering alternative funding structures, ranging from raising external capital through to placing greater reliance on either external funding or profit retention to fund investment.
- With the many pressures on funding, including staff cost inflation, the need to remunerate partners commensurately with US rivals to retain the best talent, and the imperative to invest in technology, perhaps now is the time for firms to move away from the full distribution model and retain more cash for reinvestment in the partnership.

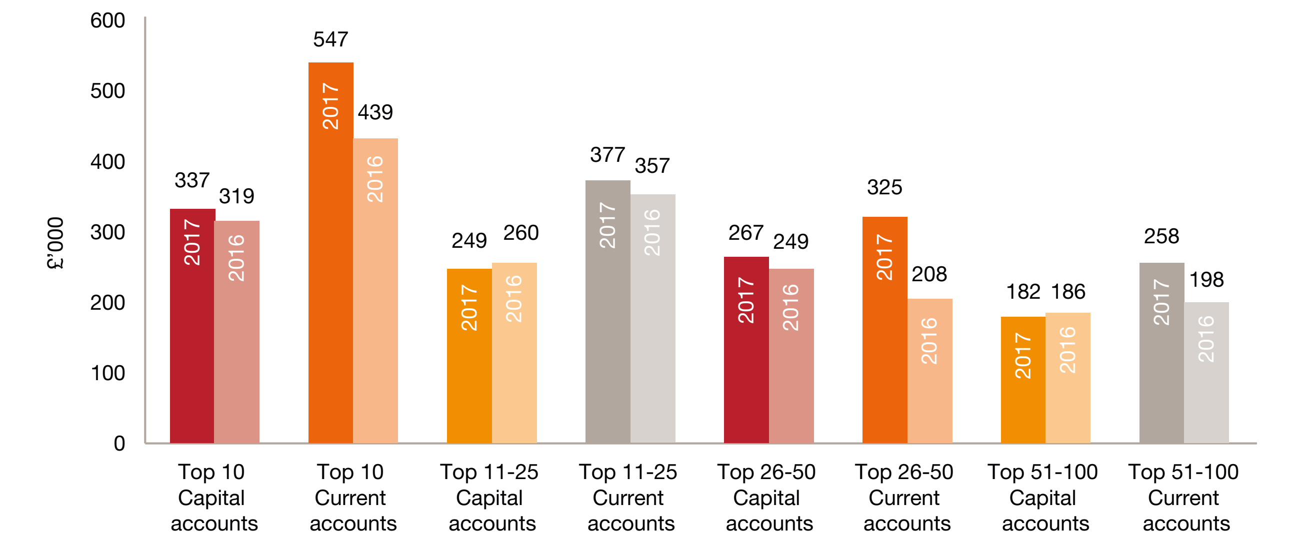
Timing of partner profit distributions

Between 50% and 58% of profit across the Top 100 firms' bandings is distributed to partners in the year the profit is made, with the majority of the remainder distributed in the following year.



Full equity partners average UK capital and current accounts balances

Capital and current accounts have increased, on average, across all bandings of firms, with the exception of capital accounts in the Top 11-25 and Top 51-100.



6 Risk

At a glance

Information Security

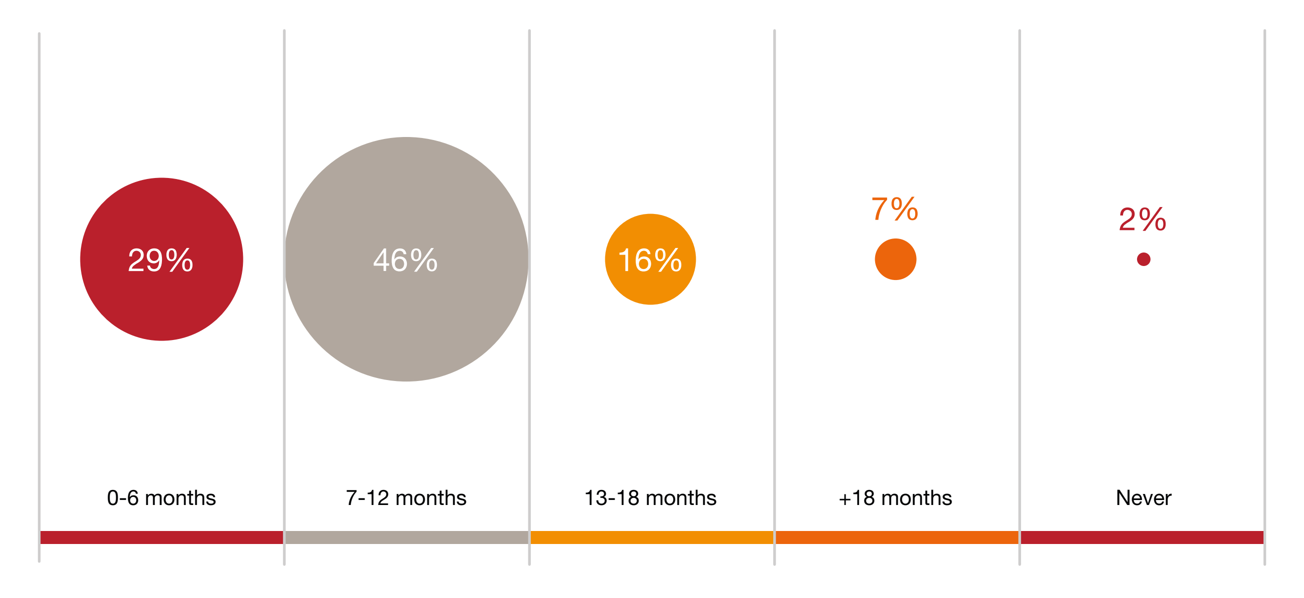
- Risk management, and particularly information security, has been thrust into the limelight in the past six months with an increasing number of incidents of loss and two global ransomware attacks which affected a broad range of organisations, including law firms. Over 60% of all law firms reported suffering some form of security incident during the last year.
- There is an increasing need for boards to be equipped with appropriate risk management and business resilience frameworks to effectively manage risks across the firm and respond accordingly in the event that security is breached.
- The most common security incidents continue to be phishing attacks. 12% of firms claim to be recipients of such attacks on a daily basis with a further 30% identifying attacks on either a weekly or monthly basis.
- The increasing threat level means it is more important than ever to have effective and tested business continuity plans and a resilience framework. It is a concern that 16% of all firms claim not to have any such framework and of those that do, only 75% test their business continuity plan annually. This presents a risk that in the event of an incident and having to invoke your continuity plan, it may not be sufficient or fit for purpose to respond to the situation.
- Following a significant attack/disruption, in our view all organisations need a centrally co-ordinated programme with clear objectives and resources. Such a structured programme will:
  - provide a visible demonstration internally and externally that there is control, and the organisation understands the tasks in hand and has a clear plan;
  - build trust and credibility across all stakeholders; ensure resources have been mobilised and are focusing on the priority areas; and
  - drive a holistic approach across all functions. This ensures that all aspects of the business are being considered and addressed; clients, lawyers, support, staff, systems and regulators.
- There should be strategic executive-level advice to support the streamlined coordination and execution of incident-related activities, plus support in implementing and running programme management of the response and technical advice to support the recovery of IT operations. If organisations don't have such a programme in place ready to be activated, external support should be engaged.

Data privacy

- The response to the incoming General Data Protection Regulation ("GDPR") has improved with 70% of firms having completed an assessment (13% in 2016) with the remaining 30% due to complete their assessment within the next six months. This is a positive result; however, from our experience of organisations in this and other sectors, there is still a high level of uncertainty as to how managing data in a GDPR regime will work in practice and with the potential for fines at 4% of global revenues, the cost of getting this wrong may be significant.

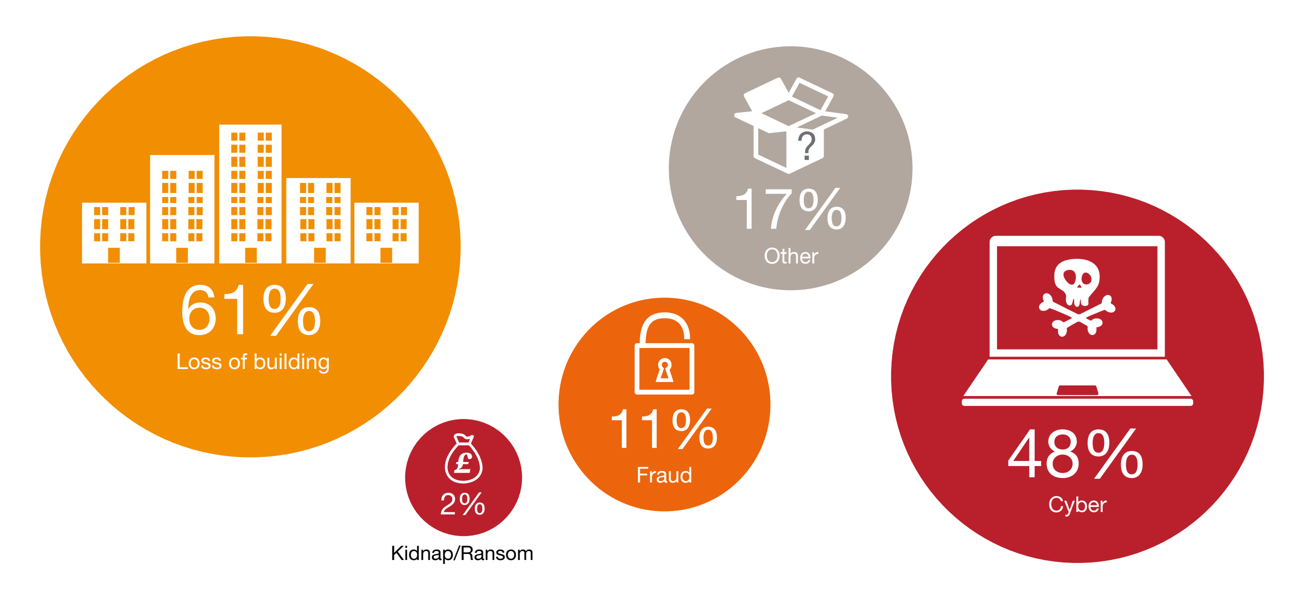
Regularity of testing Business Continuity Plans – All firms

Approximately one quarter of all law firms do not test their business continuity plans annually



Topics of crisis management exercises

Loss of building and Cyber are the most common subjects for recent crisis management exercises undertaken by law firms.



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