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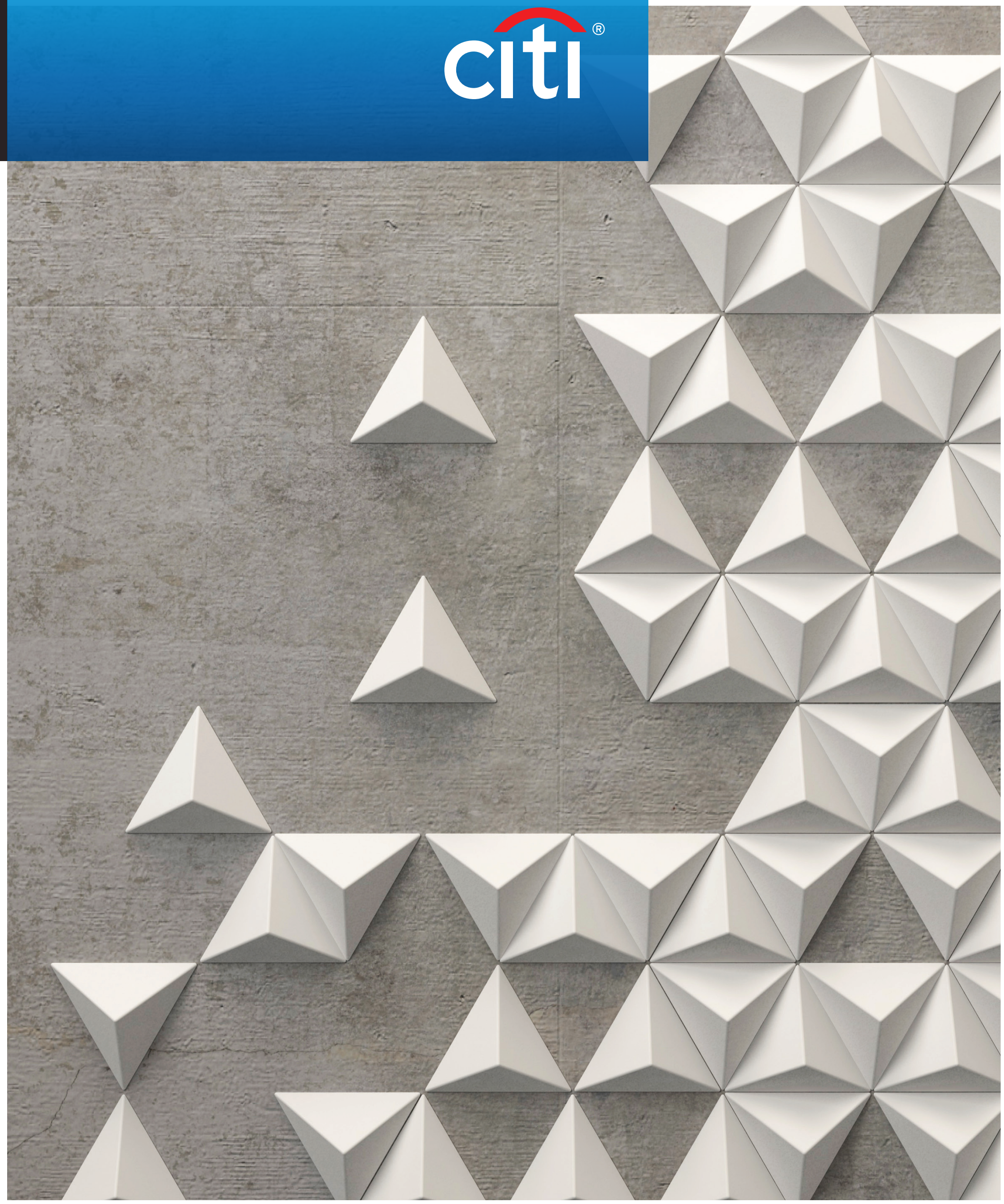


# 2018 Client Advisory

HILDEBRANDT
CONSULTING LLC

# Executive Summary

The law firm industry remains in a channel of modest demand growth with high levels of dispersion and volatility.[1,2] Revenue growth during the past several years has come primarily via standard rate increases, as realization has been under pressure and the modest demand growth has added limited lift. Headcount growth has come in the form of increased lawyer leverage, as equity partner headcount has remained essentially flat. And margin growth, where firms have been able to achieve it, has come in large part from overhead expense controls as the industry has become leaner.

Looking out to 2018, we project that industry revenue growth and profit per equity partner growth will remain in the mid-single-digit range on average. Behind these average results, we expect to see variability in individual firm performance, which will continue to drive consolidation in the industry.

A strong brand will be critical for firms to capture revenue growth in their established markets, practices, and industries. For some firms, further growth in this environment will come from expansion into new markets, practices, or industries. For many, growth will come from laterals or combinations.

Success in this market will likely come to firms who are most nimble in their response to client demands for a more efficient delivery of legal services. In the long term, success will likely come to firms who adjust their talent models to market forces and who focus on building a robust growth model that attracts, develops, and retains the best legal talent.

[1] Our analyses and projections are based on data collected from a sampling of primarily US-headquartered law firms by Citi Private Bank, as well as conversations with law firm leaders. For third-party providers of legal services, our information is mostly anecdotal. Sources include the "Citi Annual Survey Database" of 193 US-headquartered firms, including 44 Am Law 1-50 firms, 34 Am Law 51-100 firms, 47 Am Law 2nd 100 firms, and 68 additional firms; the "Citi Flash Survey", including 40 Am Law 1-50 firms, 29 Am Law 51-100 firms, 47 Am Law 2nd 100 firms and 45 additional firms; the "Citi Law Firm Leaders Survey" of 55 large firms headquartered in the US, UK, Australia, China and India; and the "Law Firm Leaders Confidence Index," which reports the forward-looking opinions of law firm leaders from 154 US-headquartered firms.

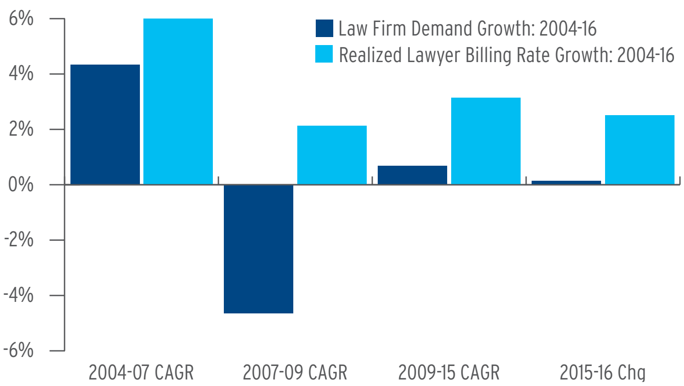
[2] Dispersion is defined as the split between firms that see demand increase and firms that see demand decline year-to-year. Volatility is defined as reverse demand growth trends from one year to the next.

## The Legal Market In 2017

### US

Through the first nine months of 2017, the US law firm industry saw revenue growth of 3.6 percent. This has been entirely driven by standard rate increases (4.0 percent) as demand declined by 0.2 percent and collections slowed by 0.9 percent.[3] The demand result is weaker than the 0.3 percent increase the industry saw during the same period of 2016, a year that ended with just a 0.1 percent increase in demand.[4] Billing rates have been the main driver of revenue growth dating back to the Great Recession itself (2007-09 in Chart 1 below).

Chart 1: Demand and Realized Lawyer Billing Rates: 2004-16




Source: Citi Annual Survey Database

And though law firms will give a portion of the standard rate increase back in the form of discounts, the remainder is responsible for the revenue growth that the industry is enjoying with three months left to the year.

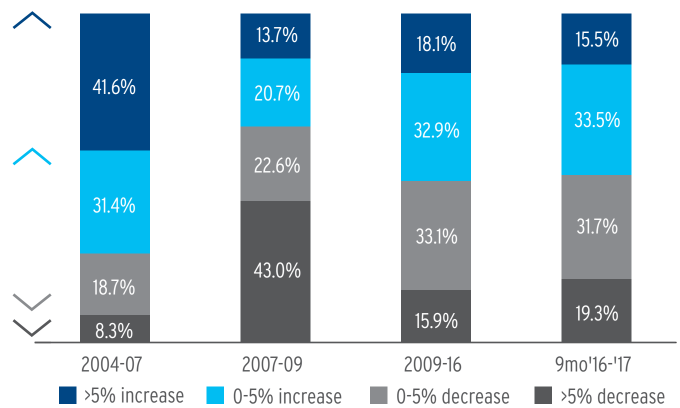
Unfortunately, expense growth of 3.8 percent outpaced revenue growth, and compressed the profit margin on average. Much of this was driven by the associate compensation increases that many firms put through, starting at the mid-point of 2016. While we expect this to moderate as we move to the end of the year, it has added margin pressure to an industry that is already experiencing top-line pressure.

Despite the slight decline in demand, firms did continue to add headcount at a 1.7 percent pace. This drove lawyer productivity down 0.6 percent. The headcount increases did not extend to the average equity partnership, which shrank by 0.5 percent. As a result, lawyer leverage increased 3 percent. Historically a driver of profit, firms are taking a close look at the mix and profitability of their leverage as, in some cases, there simply are not the hours to support it.

Depending on where firms sit in the market, they may be having very different experiences. For example, Am Law 1-50 firms have fared better thus far in 2017 than the rest of the industry. These firms saw 4.7 percent revenue growth as compared to 3.6 percent for the industry as a whole. They also saw demand improve 0.9 percent as compared to the decline of 0.2 percent in the industry. And the contrast can be seen even more clearly when compared to the Am Law 2nd 100 firms, who saw revenue increase just 0.6 percent and demand decline 2.3 percent. From a geographic reach perspective, firms with a more international footprint saw greater revenue growth than those with a more US-centric footprint (4.0 percent and 3.4 percent, respectively).[5]

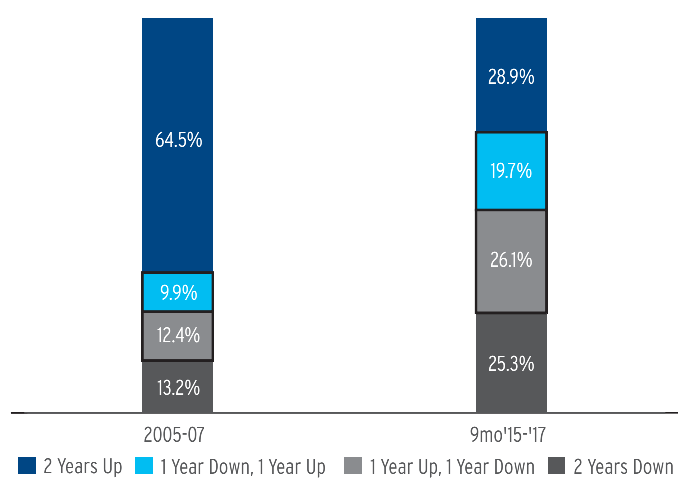
Given the different experiences seen across market segments, we continue to look behind the industry averages to track dispersion and volatility in individual firm results (see Charts 2 and 3).

Chart 2: Demand Dispersion: 2004-9mo’17




Sources: Citi Annual Survey Database and Citi Flash Survey

Chart 3: Demand Volatility: 2005-07 vs. 9mo’15-’17




Sources: Citi Annual Survey Database and Citi Flash Survey

[3] Realization, which is a fourth driver of revenue growth, will be calculated at year-end, as part of the Citi Flash Survey for the full year of 2017.

[4] It is important to note that the demand we refer to here and throughout the report is demand for law firm services, and not to be confused with the broader demand for legal services, which would include work performed by in-house counsel and alternative legal service providers. Our sense is that growth in both cases would translate to growth in the demand for legal services as a whole.

[5] Global and international firms are defined as those with more than 10 percent of total lawyers based outside the US. National and regional firms are defined as those with less than 10 percent of lawyers based outside the US.

51 percent of firms saw demand decline in the first nine months of 2017 versus the first nine months of 2016, as compared to just 27 percent of firms on average during 2004-07. This almost even dispersion between firms who grow and firms who shrink in a given period has been a constant since 2010 and it illustrates how, in this modest-growth environment, one firm's success comes at the expense of another firm.

To measure volatility in the industry, we look at two years of results to see how many firms are able to experience consecutive positive years, and by contrast, how many firms are experiencing reverse demand growth trends from one year to the next, or consecutive declines in demand. For the two-year period ending at the nine-month point of 2017, just under 29 percent of firms saw two consecutive years of demand growth, as compared to over 64 percent of firms during 2005-07. This marked increase in volatility means that even firms who grow in this challenging market will likely do so in a more jagged and unpredictable manner. Further, even more so than the average modest industry growth, we believe that it is these trends in dispersion and volatility that are primarily fueling the very active lateral market and the recent wave of consolidation.

As we look toward the year-end of 2017, we expect collections and expense growth to play a large role in how the US law firm industry finishes the year. A strong collections effort can make the year for a largely cash-basis industry which, so far, has seen a slight contraction in demand. Despite this contraction, inventory was up 4.6 percent at the nine-month point and the extent to which firms can recognize that work as revenue in 2017 will have a strong impact on the top line.

Expense growth moderation should alleviate some of the margin pressure that the industry has felt all year thus far. However, this moderation will disproportionately benefit large firms, just as the expense pressures of early 2017, much of which were driven by the associate salary increases, disproportionately affected those same firms.

Profit per equity partner (PPEP) could very well continue to increase at the mid-single-digit range that we have seen during the last several years, and is likely to grow faster than net income, as equity partner headcount on average is smaller (down 0.5 percent at the nine-month point).

## UK

The UK legal market was something of a roller coaster in 2016-17 (most UK firms have a 30th April year-end). The start of the financial year was overshadowed by the Brexit referendum in June. Following the "out" decision, activity in many areas ground to a halt resulting in a poor first quarter for many firms. Fortunately, matters rapidly improved, partly assisted by foreign corporate and real estate investors capitalizing on the weakness of sterling, so in the end most firms achieved a respectable revenue figure with revenue growth generally in the 2 to 4 percent range. Some firms with a major international presence achieved double-digit revenue growth in sterling terms, but this was largely caused by sterling's weakness.

A continuing trend has been the increasing potency of US firms, especially in London. Although only a small number of the over 100 US firms in London are covering all their costs on a fully allocated basis (including partner distributions), they have had a major impact on the market. A number of major US firms have significantly improved their market position and are regularly gaining leading roles in major M&A and private equity transactions and corporate and securities investigations. Indeed, for big-ticket M&A transactions, not only on a UK basis but Europe-wide and globally, a club of about 15 firms have emerged, including the five UK Magic Circle firms and about 10 major US firms who are consistently instructed on such deals. As a result, the next tier of UK firms has been increasingly squeezed and found it consistently challenging to obtain a role in such transactions.

A small group of strong US firms have also become far more forensic in their recruitment of lateral hires in London. They are prepared to be patient to get the best candidates and to pay significant amounts for the right person. While their proposition does not appeal to all candidates, they appear able to recruit two or three strong partners a year from each of the four largest Magic Circle firms and often more from other firms. This has caused the Magic Circle firms to react by stretching their remuneration systems to try to retain their attractiveness whilst maintaining a strong lockstep element to their remuneration system.

We are also continuing to see corporate clients exercising their buying power to ensure that law firms become more efficient (including the more effective use of client-facing technology) and deliver their services in the manner and at the price point the client expects. Many firms, even for high-end work, are now providing a significant proportion of their work on an alternative fee basis, whether a fixed fee, capped fee or otherwise, thereby providing further incentives for firms to improve their efficiency.

We also note with interest the increasing number of firms in the UK converting to the alternative business structure (ABS), enabling non-lawyer ownership and the expansion of their service offering beyond traditional legal advice. It also paves the way for investment in more efficient ways of delivering services.

US firms now have about 5000 UK lawyers working for them. Growth may have slowed, and some firms may now be more focused as political and economic uncertainties around Brexit continue, but a key group of US firms seem more committed than ever to the London market. The continued weakness of sterling and the robustness of earnings of the top US firms is providing them with a strong platform, but in some cases exposing challenges in the London office of less focused US firms. It is not just organic growth that continues. There have been multiple merger discussions between US and UK firms with some combinations resulting, some utilizing a verein type structure.

The current year appears to be going well, if not spectacularly, with revenues likely to rise by low-single-digit figures. Revenue per lawyer is still flatlining, which as employment and other costs increase is maintaining pressure on profit margins.

### Germany

Germany has also been an active market over the last year. Some of the larger international firms present in Germany have seen partner movement as the profitability of German practices has struggled to achieve that available in London or the US. However, other international firms are still opening or developing in Germany. Some German firms have engaged in merger discussions with international firms, but no major transactions have emerged.

### China

Practicing law in China continues to be challenging. Most foreign firms, with a few exceptions, have small offices. While many firms lose money, a number of firms feel they must be there because their clients require a presence. For them it is simply a "cost of doing business." Additionally, competition by Chinese firms is increasing as they become more westernized in their structure and organization. The growth of Chinese firms is faster than anywhere in the world. The result is competition for talent and increasing salaries.

### Hong Kong

Hong Kong has had a relatively subdued year with international firms increasingly seeing it as an integral part of their China practice. The higher-value IPO market has been slower, and some firms have restructured their Hong Kong offices given the high costs of operating there. Many major international firms seem committed to a China presence but have been challenged to develop a compelling offering in what has become an increasingly mature and competitive market, especially as mainland Chinese firms have developed a strong offering at a competitive price point.

### Singapore

Singapore remains an important hub for many law firms in the Asia Pacific region. Singapore has clearly positioned itself as the professional services hub for ASEAN (Association of Southeast Asian Nations), including legal services and international arbitration. We have also seen some firms refocus on Singapore at the expense of smaller offices elsewhere in the region, as a means of achieving critical mass and more consistent utilization. However, the sheer range of law firms in Singapore means that firms need a clear strategy and client offering in Singapore and the region if they are to have any chance of sustained success.

### Australia

The last decade has seen an unprecedented level of interest by international firms in the Australian market, resulting in a number of cross-border mergers. The combinations were unfortunately followed by the precipitous fall in commodity prices, which had a major impact on Australia (although it is still one of very few developed countries to have avoided a recession in the last 20 years). While law firms in Australia have always faced a competitive market, these changes and new entrants have enhanced the competition. Australian firms have, in general, significantly reduced their headcount (including partners) in recent years to cope with continued strong competition in a mature market. Fortunately, a recovery in commodity prices is now clearly helping to improve matters. In the last two years, the revenue and profitability of Australian firms have shown sustained improvement, although greater restrictions on Chinese companies and businesses investing abroad are having some impact.

### Latin America

We are seeing slow but steady consolidation in the region, both between Latin American firms and in Latin American firms combining with global players. Many foreign firms are pursuing a "best friends" strategy, but we believe there will be more global firms opting for a presence somewhere in the region. Latin America will not escape the globalization of the law practice.

### Canada

With the exception of the energy sector, Canadian firms are reporting strong performance in 2017 and expect some of the same for 2018. M&A, finance and litigation are the main drivers. More consolidation may be likely. The only cause for concern is the taxes that the government is proposing to levy on professional service firms.

### India

The Indian Government has frequently claimed in the past that it will open the legal profession to foreign firms. While this has yet to occur, there has been more talk about this possibility recently, with a few comments coming out of India that it may be imminent. Even so, we do not have any guidance on what the structure of an opening would look like. Currently, several Indian firms have loose best friends relationships with foreign firms. Eventually, India will not be able to attract the level of foreign investment it claims it wants with a closed legal system. Furthermore, long term, it is not in the best interest of the top Indian firms to remain outside of the global legal profession.

## The Legal Market In 2018 And Beyond

We expect that the industry will remain in this channel of modest growth in 2018 and in the short term beyond. We project that revenue growth and PPEP growth will remain in the mid-single-digit range in 2018. Behind these average results, we expect to see variability in individual firm performance, which will continue to drive consolidation in the industry.

Looking ahead, law firms will face a number of market forces that will challenge top-line growth. Global macro uncertainty continues to cloud law firms' ability to forecast demand levels with accuracy, while the slow-growth environment has created a hyper-competitive market. This higher level of competition extends to competition for matters, for clients, and for talent.

Beyond traditional law firm competitors, law firms will continue to face competition from alternative legal service providers, and from clients. While hard data is not readily available, it does appear that alternative legal service providers are growing rapidly (albeit from a very low base), and they are picking off low-value areas of legal work, thereby depressing demand growth for traditional law firms. In-house law departments continue to grow and keep more work in-house, although some view this as cyclical and likely to move in the other direction in time, as has happened in the past. For now, we note the rapid growth of the Corporate Legal Operations Consortium (CLOC) as evidence of in-house law departments' continued progress and drive towards efficiency. With a vision to provide a "seamless legal ecosystem that delivers corporate legal support to small, medium and large businesses with peak efficiency,"[6] CLOC has become highly visible, and has the potential to bring increased pricing pressure to law firms.

Outside the US, competition will also come increasingly from Big Four accounting firms. With the relative size of their respective legal arms (each targeting global legal revenues of USD1B by 2021), the Big Four have the scale to disrupt the legal services market, but they have not yet built the legal brand to compete for high-quality law firm business. Their main progress appears to be in continental Europe and the Asia Pacific region, where one of the Big Four recently announced the hiring of a former large international law firm managing partner.

The sheer depth and reach of the Big Four potentially makes them formidable competitors. The three largest of them combined have global revenues that exceed the aggregate revenues of the Global 100[7]. They spend more on technology and training each year than the revenue of any law firm. They are very experienced at developing multi-point client relationships and "solutions" to clients' business issues.

While this is not the first time that the Big Four have built legal services businesses, this time they are building them as part of an integrated service offering rather than a stand-alone product. Regulation in some markets (especially the US) may impede their progress as there are too many restrictions on what ancillary work they can do for audit clients. They are currently growing from a relatively low base but achieving impressive growth rates in mature markets. More clarity as to their product offering and more effective coordination across geography may be needed to achieve real success. Still, their renewed interest and recent progress in offering legal services make them a market force to watch.

Another challenge firms will continue to face will be effectively protecting themselves and their clients from the increasing threat of cyberattacks and data breaches. (See the Cybersecurity section on page 7, outlining the potential threat that firms face and some best practices towards improving a firm's cybersecurity.)

The development of client-facing artificial intelligence (AI) solutions will also continue to be a market force. In our 2017 Citi Law Firm Leaders Survey, firms reported that much of their interest now and over the next year is in e-discovery predictive coding; mass document review, e.g. for due diligence or to update contract language; and predictive analytics, e.g. to establish how a court might decide a case based on its decision making pattern. We hear firms talk about the heavy investment required to develop AI solutions, and while some firms have made initial investments in AI, there is a belief across the industry, including early investor firms, that it is only a matter of time before the major technology vendors develop a range of AI solutions, leading to the widespread adoption of AI across the industry. In the meantime, we are also watching carefully how the Big Four are approaching AI—given their global platform and their mindset around technology infrastructure investment and the more efficient delivery of large-scale legal services.

Law firm revenue growth will continue to be challenged by the modest demand growth environment and by pressure on price. Margin growth will be challenged by expense pressures like infrastructure investments, marketing and business development costs, additional insurance premiums (particularly related to cybersecurity), and the rising costs of talent. It will be the firms who can grow profitably, by increasing both revenues and margins, who will distance themselves from the growing number of firms who cannot meet both challenges.

[6] www.cloc.org

[7] "The 2017 Global 100" (*The American Lawyer,* Sept. 25, 2017)

## Managing Cybersecurity: Adapting to New Risks

Law firms have become appealing targets for cyber criminals, because law firms store highly sensitive and confidential client information and often lag behind in their cybersecurity practices. Recent high profile breaches of law firms show that the consequences of a data breach can be catastrophic. No firm is immune to cyberattack, but there are ways to lower the likelihood of a successful attack.

**A risk-based approach.** It is important for each firm to approach cybersecurity by identifying its own unique risk profile. In determining a firm's risk profile, it is important to consider (among other things): (i) who has access permissions to sensitive data; (ii) whether employees use mobile devices for work; (iii) which personnel are in charge of IT security; and (iv) the sectors in which the firm does business. Understanding the unique risks of the firm is crucial to tailoring an effective security plan.

**Master the fundamentals of cybersecurity.** Hackers often take the path of least resistance when it comes to targeting law firms. While many firms may not have the resources to implement state-of-the-art security, most firms can implement some fundamental security measures that will deter many would-be attackers. The specifics of these fundamental measures will vary depending on the size, culture, risk profile, and client base of the firm, but are likely to include things such as changing passwords on a regular basis, updating software, and training employees to avoid email scams.

**Some key best practices.** Beyond the most basic principles of cybersecurity, the following are some best practices to improve a firm's cybersecurity:

1. Understand the firm's data, such as what data the firm stores, where it is stored, whether it is encrypted, and who can access it. Firms should identify what data is especially sensitive or may require special treatment and factor that into their cybersecurity strategy.
2. Implement layered defenses, i.e. combine multiple security controls that each focus on a specific area where malware could attack. By working in concert, these layers of security offer a better chance of stopping intruders from breaching a firm's networks than using a single solution.
3. Have an incident response plan for responding to data breaches. Factor in the specific make-up of the firm, such as the resources available, the type of data stored, and where the data is stored. The entire business should be involved in preparing an incident response plan with representation from executive management, the firm's general counsel, communications, IT, and information security.
4. Consider obtaining cyber insurance to cover cyber risks. Firms should consider their unique risks and systems in evaluating cyber policies.
5. Review and revise data security policies and practices. Firms should know what policies or practices they have in place relating to data security and consider creating policies for areas of risk that are not covered. For example, a firm may want to consider implementing a policy allowing for remote wiping of the company-provided mobile devices in case the device is lost or stolen.

## Where Will Revenue Growth Come From?

Brand will remain a difference maker for driving top-line growth in this market. In 2016 and thus far in 2017, we saw firms with strong brand names outperform the market. Interestingly, in the same period, we saw this phenomenon manifest itself at both ends of the market, as a number of the largest firms in the market and the smallest (many of them boutique firms) capitalized on their brand names, producing stronger results than mid-market firms. The ability to build strong brands has not only been reflected in greater demand growth, but stronger rate increases than the broader market and less pricing pressure than the norm for those firms.

Firms will also grow by expanding into new markets—be they new geographies, practices, or industries.

**Geographic growth opportunities.** For 2018 and beyond, firms tell us that they see Asia as both a challenge and opportunity. Many firms simply feel they have to be present in China, Hong Kong, and Singapore because of the rapid growth occurring in Asia, regardless of the challenges. We expect further expansion of Chinese firms outside of China. Europe is generally viewed as a challenge with the exception of Paris. London is viewed by many firms as continuing to be an opportunity, though Brexit will pose challenges. Firms with a more robust continental Europe footprint could be better positioned to gain market share as Brexit plays out if some of the business currently done in London leaves the UK. In the US, firms generally point to opportunity in New York, California, Texas, and in Washington DC.

**Practice area growth opportunities.** Looking ahead, we hear general optimism about mergers and acquisitions (particularly private equity-driven), white collar and regulatory investigations, tax advisory, infrastructure and project finance, and cybersecurity-related work. Firms are more optimistic about litigation (including IP litigation) than they have been in several years, although it remains a challenging practice for many. Some in the market point to the growth in available funds from litigation funders as a factor in the resurgence of litigation. A recent Wall Street Journal article[8] noted a spike in interest on the part of private equity funds, family offices and others as an investment opportunity not tied to the public markets. The article also pointed to greater acceptance among law firms who were initially skeptical when litigation funders burst onto the scene ten years ago. Conversely, we hear universal agreement that patent prosecution is challenged, and we have seen some firms move away from that work. Firms are mixed in their outlook for bankruptcy and restructuring, capital markets, and banking and finance.

**Industry growth opportunities.** Firms are optimistic about the prospects for growth in legal work coming from the technology, healthcare, energy, life sciences, pharmaceuticals, and private equity sectors. They anticipate challenges relating to the real estate and retail sectors. We hear mixed opinions about the level of opportunity coming from the financial services sector, as firms point to the litigation run-off, the level of pricing pressure, and the cybersecurity and data privacy requirements of financial services clients.

**Growth through laterals, mergers and acquisitions**. Growth will also likely continue to come by buying growth, through laterals and combinations. Laterals have become a larger proportion of new equity partners but still come with higher levels of risk than partners promoted from within. As part of our Citi Law Firm Leaders Survey, we asked firms how successful their lateral hires have been based on their own definitions of success, looking at the hires made in the past five years. Firms reported that just 59 percent of the laterals hired during 2011-16 were considered a success. This is consistent with the results we have reported for the five years prior, with the average never being above the 50s. For comparison, in recent years we have asked the same question about partners who were promoted from within and the reported success rate for the same time period is materially higher at 72 percent. As with any data, the averages belie the success that some firms reported having in their lateral acquisitions. But when we looked behind the averages at the firms who reported the greatest success in hiring and integrating laterals, the factors that most clearly correlated with success were simply hiring fewer laterals and being more considered in the hiring decisions. We also hear anecdotally that firms have seen more success in their lateral hiring as they have moved their focus to bringing on groups of lawyers rather than individual lateral partners, particularly where the firms have made every effort to integrate the groups into the broader partnership.

Though we have seen combinations at all levels of the market in recent years, many have taken the form of large firms acquiring smaller firms who have experienced some performance issues. This is directly related to the dispersion and volatility trends discussed earlier. We expect further combinations in the short-to-midterm, particularly among mid-market firms that either merge with each other or combine with larger firms. As we study the combinations that have occurred, we are particularly concerned about the business case for mergers that are seemingly done simply to capture market share. These combinations will never perform as well as tactical, synergistic moves to strengthen market positions or enter new markets. We also do not subscribe to the notion that a combination can remedy underlying systemic challenges that both participant firms are facing independently, as some combinations have sought to do.

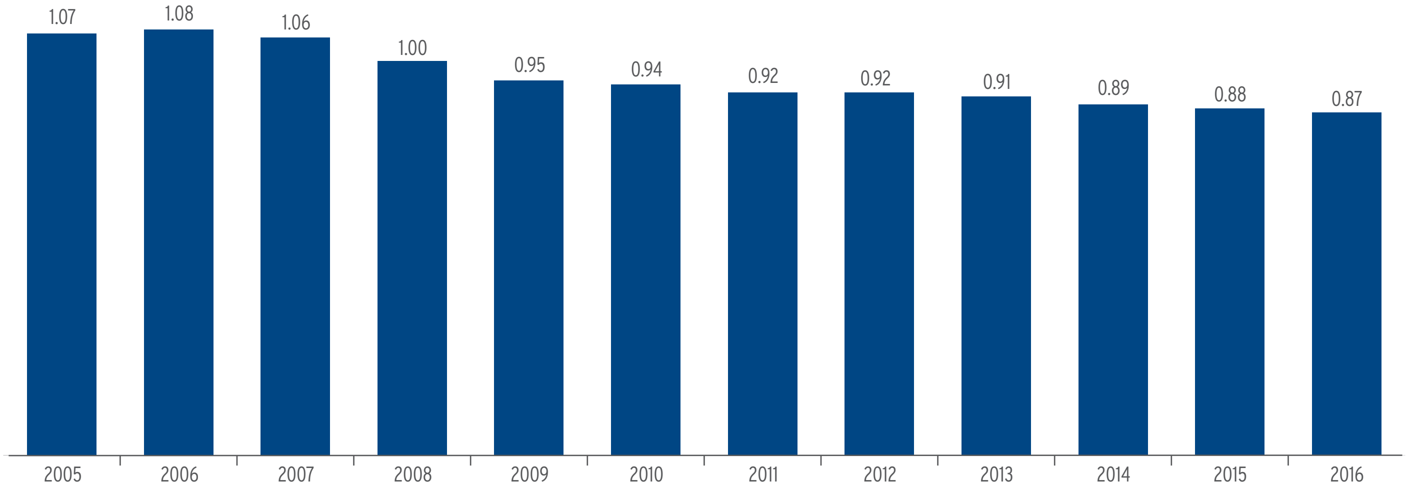
### Where Will Margin Growth Come From?

As firms think about growth, they must also pay close attention to their margins. The industry has become much leaner in the years during and since the Great Recession as firms have paid close attention to slowing the growth of expenses, or in many cases, cutting expenses. However, costs are on the rise, while modest law firm demand growth and heightened competition have created a buyer's market, fueling pricing pressure. We see pricing pressure in the industry manifest itself in the difference between the pace at which firms put their rates up and the amount of that increase that firms are able to collect. And this erosion of realization has been constant, declining each year from 2010 to 2016.

Law firms have been largely reactive to these pressures by providing pre-negotiated discounts or alternative fee arrangements (AFAs), which have also contributed to eroding realization and profitability in most cases. In fact, a few firms have told us that they have recently declined work where discounting pressure made it unprofitable for the firm. However, we have also heard a more optimistic view of law firms' ability to respond to pricing pressure in ways that may stem realization erosion, and may even be accretive to realization and profits. In our forward-looking Law Firm Leaders Confidence Index, law firm leaders have finally predicted some abatement in pricing pressure, after predicting declines in realization dating back to the fourth quarter of 2007. We do not infer from this that clients will stop asking for discounts, and we certainly do not hear that as we speak to firm leaders. But we do infer that some of the changes that firms have made in how they deliver legal services have started to move the needle on realization and profitability from within. This includes hiring pricing specialists and project managers to work on these matters. These professionals are adding rigor to the process with profitability analyses, and improving their firms' approaches to pricing, budgeting, and staffing. The move at many firms to a more flexible leverage model has also been an important development, something that we will discuss in more detail later in this report.

[8] Sara Randazzo, "Investors Flock to Back Lawsuits in Exchange for a Cut of Settlements" (The Wall Street Journal, Sept. 18, 2017)

Chart 4: Professional and Administrative Staff to Lawyer Ratio[9]: 2005-16



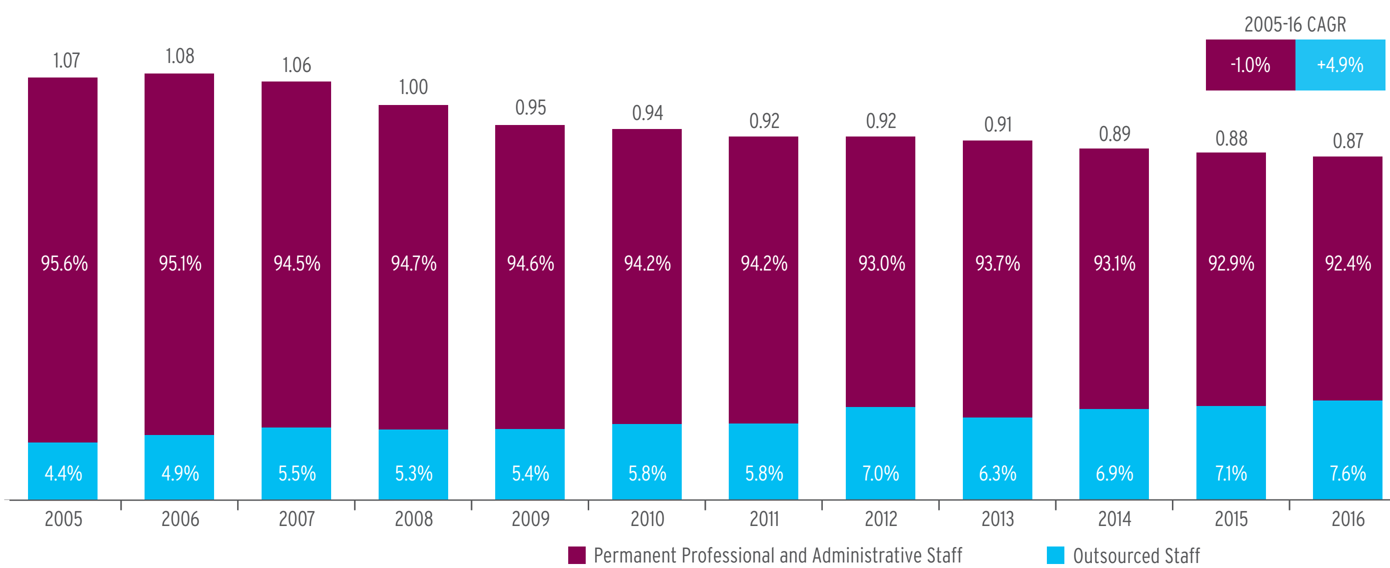

Source: Citi Annual Survey Database

The leveling of AFAs has also helped to alleviate some of the pressures on the top line in recent years. The purported takeover of the AFA has stalled at about 16 percent of law firm revenue for four years running. That said, we hear anecdotally that the prominence of AFAs differs across practices. And beyond AFAs, firms still face a high proportion of pre-negotiated discounts.

As mentioned earlier, the focus on expenses has gone a long way in preserving margins. Firms reacted quickly in slowing expense growth to match the slowed revenue growth. A large part of this focus has been the move towards efficiency in law firms' usage of office space. Outside of salary costs, occupancy expense is by far the largest expense line item on a law firm's income statement. The move towards efficient layouts, same-size smaller offices, interior offices—essentially everything short of open floor concepts—has sought to minimize as much as possible the effect of this large expense item on margins. For several firms, the creation of centers in lower-cost locations to handle both back office and low-cost legal work has also enabled them to manage expense growth.

Beyond moving to lower-cost locations, we have also observed a more general trend in becoming leaner in the total professional and administrative staff to lawyer ratios at law firms. This downward trend has been primarily driven by the reduction in administrative staff (as we have also seen the growth in certain professional roles, including pricing specialists, project managers, marketing and communications staff). Chart 4 shows the broad trend of reducing the total professional and administrative staff to lawyer ratio each year since 2007. Chart 5 shows that firms achieved this primarily

Chart 5: Permanent Professional and Administrative Staff vs. Outsourced Staff: 2005-16




Source: Citi Annual Survey Database

[9] Includes outsourced staff

by reducing both the proportion and the number of permanent staff, while the proportion and number of outsourced staff increased. The move to outsourcing is consistent with firms' focus on reducing expenses. While firms were reducing the ratio of total professional and administrative staff to lawyers, the growth in their salaries actually outpaced the growth in total expenses (2.7 percent vs. 1.9 percent per year during 2008-16) and worked counter to the expense management effort. We heard from firms that as they looked closely at the number of total professional and administrative staff during this period, they not only shifted to more professional staff, but also carefully considered their skillsets and essentially opted for "quality over quantity". This up-tiering of senior professional staff in particular was a primary factor in the salary increases. Meanwhile, the average cost of outsourced staff remained relatively flat during the same period.
The increased outsourcing of business functions, and the associated cost benefit, served to balance the expense increase that firms saw in permanent staff, and 72 percent of firms reported seeing a direct positive effect to their firm's profitability through outsourcing.

Despite the savings associated with outsourcing, firms reported that they are most likely to have outsourced office facilities and help desk functions—both longstanding trends. On the other hand, few firms have outsourced human resources, finance, or procurement functions. Looking ahead, there may be little opportunity left for firms to continue to become leaner in professional and administrative staff per lawyer. However, outsourcing additional business services could be worth exploring if firms determine that third parties can provide a better non-legal service than the law firm can provide for itself. Additionally, we may see a continuation of the trend in moving back office and low-cost legal work to captive low-cost centers.

Perhaps the greatest opportunity for firms to manage expense growth is in closely examining whether there is an appropriate match between the costs associated with the various categories of salaried lawyers who comprise their leverage, and the revenue those lawyers generate.

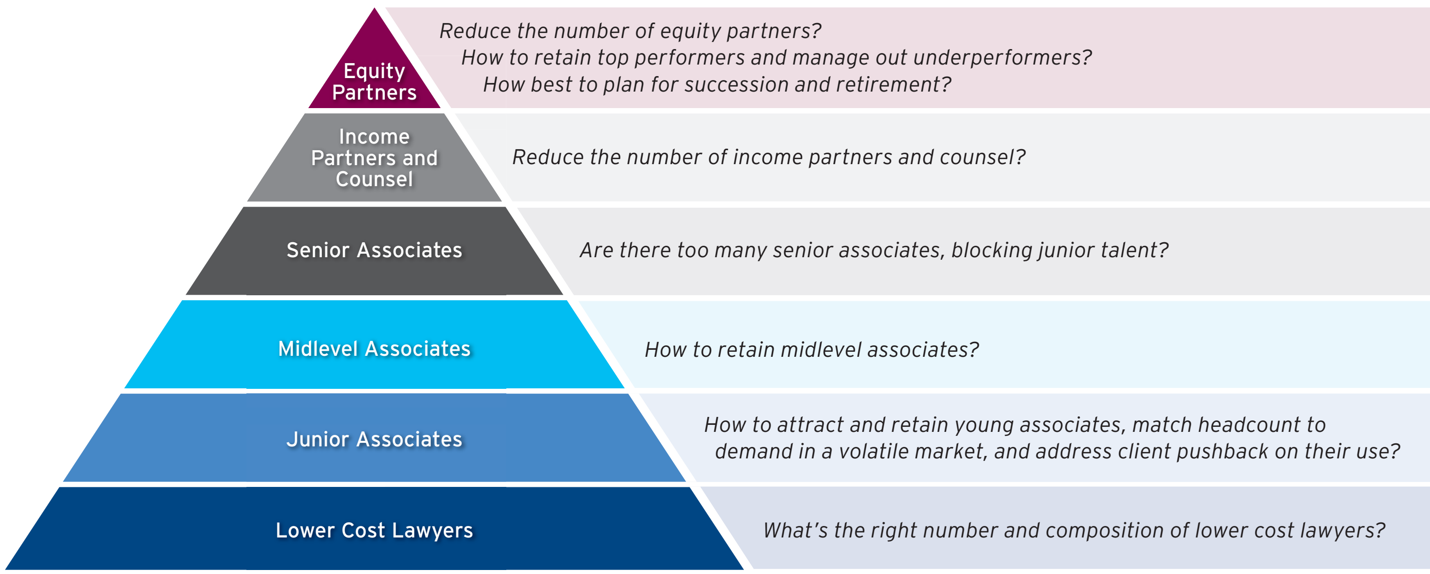
### How Will Firms Fund Growth?

Finally, as firms grow, they will need to decide how to fund their growth. Many firms have turned away from debt and toward raising partner capital. We have seen this reflected in our data as the average capital requirements of partners has increased. We have also seen this reflected in our lending portfolio as our total loans outstanding to partners, much of it in the form of partner capital loans, has exceeded our total outstanding to law firms over the last several years. However, in the most recent few years, we have seen firms become more willing to take on debt in a low rate environment, particularly as they have moved or refitted existing office space—in many cases to improve the efficiency of their layout. The decision to raise capital or take on debt is not only driven by interest rates, but also by a desire to spread the cost more equitably based on which partners stand to benefit the most from the investment.

## The Talent Model In 2018 And Beyond

As firms adapted to changed market conditions in recent years, we also observed shifts in the size and composition of the talent model—from the partnership through to all components of a firm's typical leverage. Looking ahead, we anticipate further changes to the leverage model in response to market pressures. And as the industry has slowed equity partner growth over several years, the result is an aging population. We anticipate an onslaught of retirements in the coming years, raising questions about the size and shape of law firm partnerships in the future.

Chart 6: What Law Firm Leaders Told Us: Talent Model Challenges




### How Will Firms Create And Retain A High-Performing Partnership?

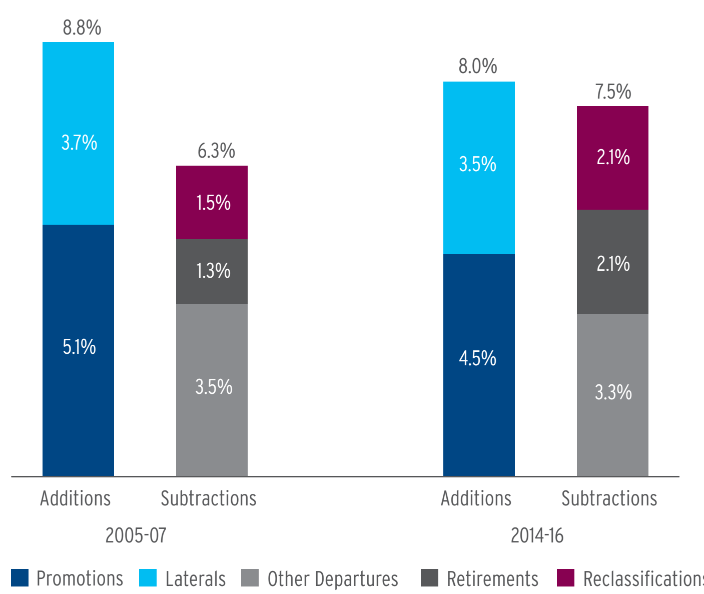
In recent years, law firms have aimed to make very few net new equity partners as growth in demand has remained modest. To manage the net number so closely, gross movements both in and out of the equity partnership have increased (see Chart 7).

The increase in number of departures has been driven to some degree by an increase in retirements, as baby boomer partners reach retirement age. We have also seen an increase in de-equitizations and departures, as firms have managed underperformers out of the equity partnership.

Movement into partnerships has also declined. This decline has been driven entirely by a slowed pace of promotions, as lateral growth levels have remained relatively steady.

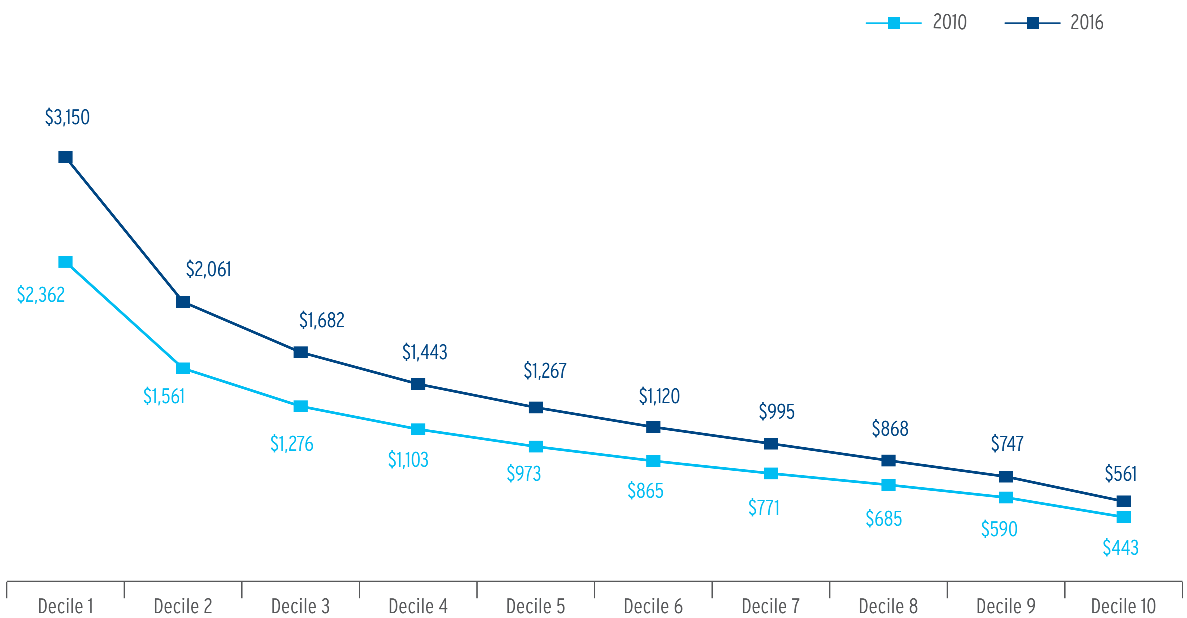
Law firm leaders tell us they expect to continue carefully managing growth in their equity partner ranks, and for some, this means further reduction in the size of their equity partnerships. These projected growth trends raise issues around career opportunities for talented salaried lawyers and succession planning as partners reach retirement age. They also tell us that ensuring that the current partnership is a high-performing one and retaining top talent are critical. While a firm's culture plays an important role in retention, rewarding top performers appropriately in a highly competitive market for talent will be critical.

Chart 7: Equity Partner Mobility: 2005-07 vs. 2014-16




Source: Citi Law Firm Leaders Survey

Chart 8: Equity Partner Compensation by Decile: 2010 vs. 2016




| PPEP CAGRs 2010-16 | |
|---|---|
| Decile 1 | 4.9% |
| Decile 2 | 4.7% |
| Decile 3 | 4.7% |
| Decile 4 | 4.6% |
| Decile 5 | 4.5% |
| Decile 6 | 4.4% |
| Decile 7 | 4.4% |
| Decile 8 | 4.0% |
| Decile 9 | 4.0% |

Source: Citi Annual Survey Database

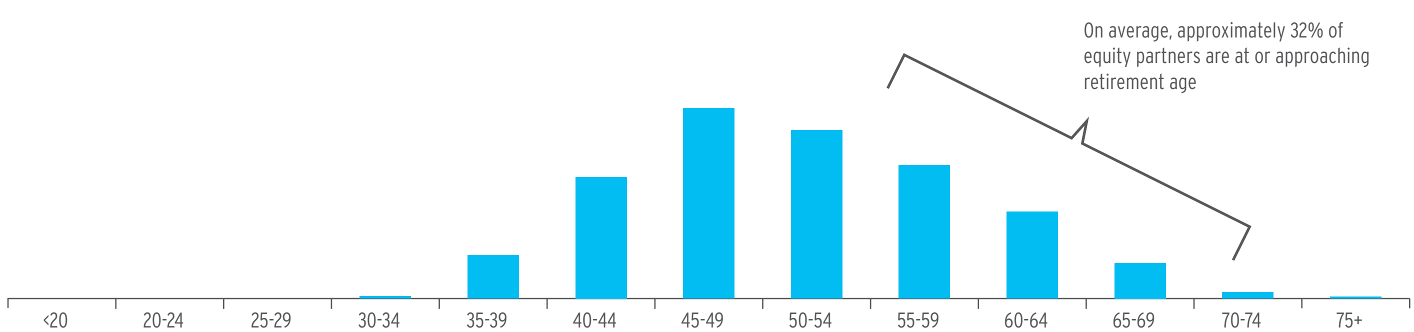
Rewarding top performance to remain competitive is a trend we have seen in recent years, illustrated in Chart 8.

The graph shows that while average partner compensation has grown during 2010-16, the level of growth has been greater for the highest paid partners. Indeed, even among the few remaining lockstep and modified lockstep firms, we have seen modifications to the lockstep ladder and the introduction of bonus pools to reward top performers and remain competitive in the market.

Beyond rewarding today's top performers, the need for succession planning will become even more acute over the next few years. Slowed growth in equity partnerships over the past several years has produced an aging demographic, where, on average, 32 percent of partners are at or approaching retirement age (see Chart 9).

If firms continue to make modest additions to their equity ranks, the proportion of partners at or near retirement age will dramatically increase.

Chart 9: Equity Partner Demographics as a % of Total Equity Partners: 2016



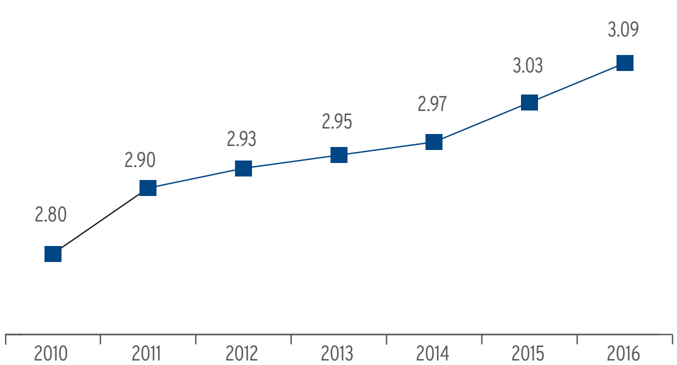

Source: Citi Law Firm Leaders Survey

While this trend underscores the importance of succession planning, it raises questions about the size of the average equity partnership in the future. It also highlights the challenge firms face in retaining their best and brightest lawyers who aspire to become equity partners in an industry where the opportunity to become an equity partner has become slim. While some firms might deliberately shrink their equity partnerships, others are likely to become more focused on filling the gaps created by the slowed additions of recent years and the accelerated departures in the future. They will either do this through acquiring laterals, or increasing the rate of promotions through development of the talent pipeline in their leverage models.

### What Will Happen To The Leverage Model?

As firms have held the size of the equity partnership relatively steady, they have seen consistent growth in the average leverage model, as shown in Chart 10.

Chart 10: Lawyer Leverage: 2010-16



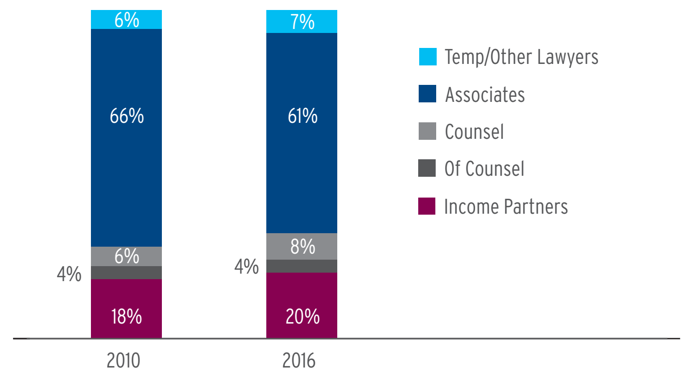

Source: Citi Annual Survey Database

This growth has been driven primarily by growth in senior salaried lawyers, namely income partners and counsel. This shift has created a more senior leverage model as firms have moved proportionately away from associates and towards counsel and income partners, as seen in Chart 11.

Law firm leaders have told us that they view the shift to a more senior demographic as creating potential roadblocks to younger talent, making it harder to retain talent. And in an environment of rising expenses, there is an opportunity for firms to examine whether there is an appropriate match between revenue generated by—and the cost of—these senior lawyers.

Over the next two years, firms have told us that they will shift to a more junior demographic, likely in response to market pressures for more efficient legal services. Given these long-standing pressures, and the increased cost of permanent leverage, we have seen the increasing flexing of leverage at firms across the industry. These include greater use of temporary, contract and off-track lawyers. We would expect to see more flexibility in the leverage model in the coming years.

Chart 11: The Composition of Leverage: 2010-16




Source: Citi Annual Survey Database

We also expect that AI will have an impact on the leverage model. First, building and maintaining AI solutions will require additions and modifications to the composition of a law firm's leverage. Firms will need lawyers and knowledge management experts to develop content, and more technology experts, such as programmers and coders, to work on AI solutions, ideally generating fees for the firm. It is also likely that some firms will focus on the technology skill set of associates in their hiring decisions. Second, the wider-spread adoption of AI will likely affect the size of leverage, particularly for firms who have built their leverage models to handle large-scale, commodity work.

As law firm leaders look forward to 2018, the vast majority reported plans to increase the number of associates at their firms in the Citi Law Firm Leaders Survey, as compared with roughly 1/3 of firms planning to add income partners and counsel.

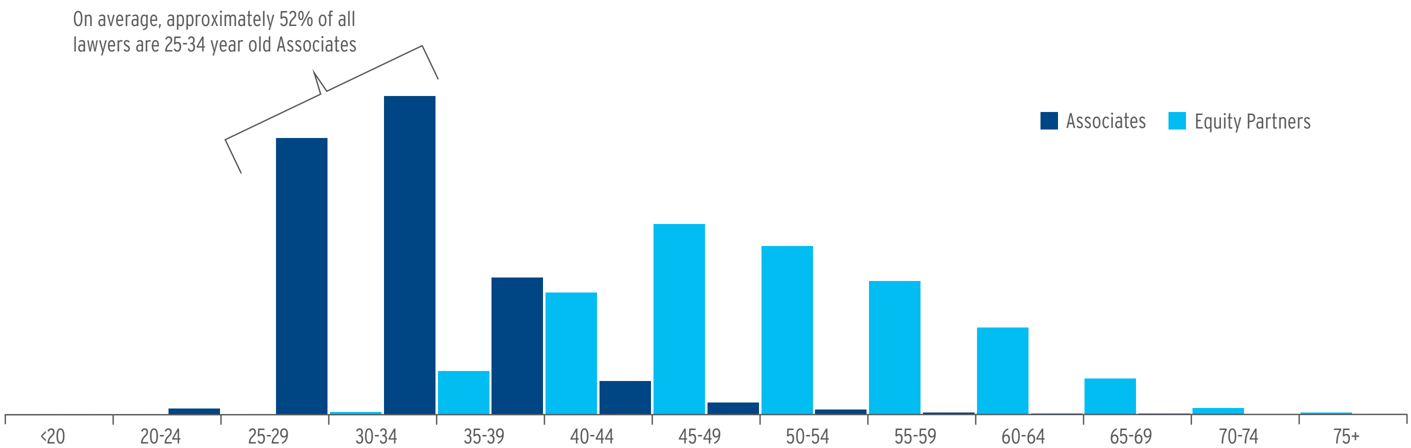
The shift toward associates comes with its own set of challenges. Given the increased volatility of law firm demand performance from one year to the next, law firm leaders tell us it will become harder for firms to match associate hiring decisions to demand levels in a two-year timeframe. The increased cost of associates places even greater pressure on firms to have the right mix of lawyers to generate hours and revenue.

Firms will also face the challenge of attracting and retaining talent. The number of candidates entering US law schools has declined over a number of years (although the decline may have finally stopped, as enrollment was flat in 2016). Of the smaller pool of law school graduates, some might be lured away by other industries, either before they join a law firm or early in their law firm careers.

Competitive compensation will remain a critical tool in talent attraction and retention, evidenced by a reduction in attrition levels following the recent associate salary increases. Law firm leaders tell us that beyond compensation, the firm's culture and the ability to do challenging and rewarding work are the most important factors in attracting talent. And while those factors remain important in retaining talent, mentoring and clarity in an associate's career path at the firm also become increasingly important.

As we highlighted in the above section, the average law firm will face gaps in their equity partnerships in the future. The greatest opportunity for firms to grow, if not maintain, the current size of their partnerships exists among their associates. As Chart 12 shows, the number of 25-34 year old associates represents approximately 52 percent of a law firm's total lawyers on average. Based on recent equity partnership growth trends, these associates are not currently making it though the pipeline in enough numbers to fill the potential gaps that firms will see in their partnership. For firms who want to maintain or grow the size of their partnerships, a greater focus on developing, retaining and promoting their associate population will be a key opportunity in the years ahead.

Chart 12: Equity Partner and Associate Demographics as a % of Total Equity Partners and Associates: 2016




Source: Citi Law Firm Leaders Survey

# Conclusion

Despite the challenges outlined in this Client Advisory, we believe that the law firm industry will continue to grow, albeit modestly. It remains one of the most profitable personal services businesses in the world. That said, we expect to see further consolidation and some law firm dissolutions as weaker firms lose their ability to compete.

Technology, including AI, will help reshape the law firm industry, while the possibility of a cybersecurity breach (and the associated reputational and financial risks) has rapidly become one of the biggest concerns of law firms today. We believe that the firms who harness the emerging technologies and who focus on protecting their clients and themselves from cybersecurity breaches will be even stronger in the future.

While there are those who suggest that law firms cannot adapt to the shifting demands of clients and the changing competitive environment, we take a different view. We believe that law firms have historically been resilient in the face of changing market conditions and while change has come slowly, the law firm of 20 years ago bears little resemblance to the law firm of today.

In the longer term, the way firms adapt their talent models in response to market pressures for more efficient legal services, and the onslaught of equity partner retirements likely to occur in coming years, will be an important factor in the growth trajectory and sustainability of law firms across the industry.

There is no doubt that the market will continue to favor firms with a strong brand in specific practice areas and industries, while we expect that the firms who continue to brand themselves as being "all things to all clients" will face challenges in this market.

Beyond maintaining a strong brand focused on key practice areas and industries, the strongest performing firms will have built solid client relationships and a powerful talent model. Further, their strong leadership, extending to their high-caliber and empowered executive talent, who are focused on growing both revenue and margins, will continue to set them apart from the broader industry.

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