2020 Client Advisory
Executive Summary

2019 has been a good year for the law firm industry¹. While full year growth results are unlikely to match the strong average industry performance we saw in 2018, we have seen top-line growth similar to other post-recession years. Rate increases were the major driver of revenue growth, while demand growth was modest, and the collection cycle continued to lengthen.

Behind the averages, we saw different segments of the legal sector performing well. We also saw more dispersion² than we saw in 2018—a typical feature of the post-recession era. Meanwhile, expense pressure eased as 2019 progressed, as firms absorbed the full impact of mid-2018 associate salary increases.

Looking forward, we know that many firms are concerned about the risk of a recession and the underlying macroeconomic and geopolitical volatility. However, we do not anticipate a recession in 2020. That said, we believe it is now prudent for law firms to prepare for less certain times ahead. We also note that firms are facing many talent-related challenges: retention at all levels, the rising cost of talent, and how best to plan for the departure of rainmakers and senior partners.

There are many positive trends in the industry. Across most revenue segments, firms are poised to grow, and are placing even greater emphasis on innovation, efficiency and practice profitability. They are also investing more in business development and artificial intelligence. While alternative fee arrangements remain a small part of revenue for many firms, this billing option is becoming profitable for a growing number of firms.

Firms are also making changes to their leverage models. Leverage is expected to increase, with the workforce becoming broader, more flexible, lower cost and more profitable. Firms are also expected to expand their equity partnerships, aided by lateral growth strategies that are becoming more successful than we have ever seen before.

We project that 2020 top-line growth for the industry will be in the range of between 5 to 6 percent, with profit per equity partner growth in the mid-single-digit range. We also anticipate continued dispersion and volatility, leading to further consolidation.

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 228 US and UK-headquartered firms, including 43 Am Law 1-50 firms, 40 Am Law 51-100 firms, 57 Am Law Second Hundred firms, and 88 additional firms; 166 firms from the “Citi Flash Survey”, including 37 Am Law 1-50 firms, 30 Am Law 51-100 firms, 49 Am Law Second Hundred firms and 50 additional firms; the “Citi Law Firm Leaders Survey” of 53 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 157 firms.

² Dispersion is defined as a near even 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 2019

US

At the start of 2019, it looked unlikely that the US law firm industry would achieve growth levels close to that reported in 2018. But, as the year progressed, we saw an improvement in firms’ financial performance. True, growth levels for the first nine months of 2019 were lower than that achieved in the same period in 2018—5.1 percent compared with 6.3 percent. However, the growth trajectory was positive. We are therefore confident that full-year figures for 2019 will be solid, if not spectacular.

As in other post-recession years, the primary driver of revenue growth was an increase in billing rates, rather than demand growth. During the first nine months of 2019, billing rates grew by an average of 4.7 percent—the highest growth since before the recession. By contrast, demand grew by just 0.9 percent—a far lower figure than seen in 2018. Firms told us that, while they remained busy across both transactional and litigation practices, it was challenging to deliver growth comparable to that achieved in 2018. More positively, demand growth accelerated as 2019 progressed.

A significant drag on revenue growth was the lengthening of the collection cycle—a trend we have seen for some time. By the end of September 2019, inventory had risen by 6.7 percent. One of the drivers of this trend was a 4.5 percent increase in accounts receivables—largely caused by clients delaying payment of their bills. Another driver was an increase in unbilled time, which rose by 9.1 percent. This suggests that full-year revenue results for 2019 have the potential to be strong, so long as firms remain focused on collections.

As the year progressed, we also saw some easing of firms’ expense pressure, as the impact of the mid-2018 associate salary increases faded. Through the first nine months of 2019, expenses rose by 4.7 percent, moderating significantly from the start of the year.

That said, a 2 percent increase in total lawyer headcount caused lawyer compensation costs to rise by 5.3 percent. Most of this headcount increase came from growth in salaried lawyers rather than in equity partners, which firms continue to manage closely. In the first nine months of 2019, equity partner numbers rose by just 0.3 percent. Meanwhile, operating expenses rose by 4.3 percent, largely driven by technology, professional staff and real estate-related costs.

Strong total lawyer headcount growth, coupled with minimal equity partner headcount increases, caused firm leverage to rise by 2.4 percent. But, with lawyer headcount growth outpacing demand growth, we saw a 0.7 percent fall in lawyer productivity. In effect, firms paid their lawyers more for lower production.

Looking across the industry, Am Law 50 firms reported a 0.8 percent increase in demand in the first nine months of 2019, building on an already strong performance during 2018. However, demand growth was higher among other Am Law 200 segments. The best performing Am Law 200 segment were Am Law 51-100 firms, which reported a 1.8 percent rise in demand. Also beating the Am Law 50 firms were the Am Law Second Hundred, which reported demand growth of 0.9 percent. The demand environment was less positive for niche firms–practices that fall outside the Am Law 200. During the first nine months of 2019, these firms saw a 1.1 percent decline in demand. This reverses the strong demand increases achieved by these firms in 2018.

Within each market segment, dispersion remained a feature (see Chart 1). Positively, a majority of firms reported demand growth through the first nine months across all Am Law 200 segments. This demand growth has particular significance among Am Law Second Hundred firms. In recent years, the majority of this market segment has tended to report declines in demand.

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Chart 1: Demand Dispersion by Am Law Segment 9mo ‘18–’19

Throughout 2019, we continued to see an active lateral recruitment market. This market remains the primary driver of consolidation in the US legal industry.

Beyond the law firm industry, we saw the continued growth of alternative lower cost service providers. The Big Four accountancy firms also continued their low-key experimentation with the US legal market. At present, the Big Four remain focused on relatively niche legal services—such as immigration, labor, cybersecurity and risk management—in the US, typically offered via alliances with local law firms.
Overall, we anticipate a solid year end for 2019, with top-line growth likely in the 5.5 to 6.5 percent range, assuming firms can collect their inventory. Behind the industry averages, we expect continued dispersion across, and within, market segments. We also expect average industry profit per equity partner (PPEP) growth to be in the mid-single-digit range.

**The UK**

More than three years after the country narrowly voted to leave the EU, the UK’s future relationship with its main trading partner remains unresolved. In an attempt to break this ongoing political impasse, a general election is scheduled to take place on December 12.

Notwithstanding the ongoing political challenge of Brexit, we anticipate that the UK legal sector will perform well in 2020, building on the success of 2019. As the country’s future relationship with the EU becomes clearer, we anticipate a boom in Brexit-related advisory work. That said, ongoing political uncertainty has caused certain market segments, notably real estate, to soften.

**Germany**

Germany has, so far, narrowly avoided entering a recession during 2019. However, it is possible that a recession will occur soon. More positively, the German M&A market has remained strong, buoyed up by private equity houses acquiring large capitalization German assets. In light of these varying economic indicators, the prospects for the country’s legal profession are likely to be highly market segment dependent.

**Hong Kong**

The political upheavals, and ongoing street violence, in Hong Kong have now made headlines around the world for several months. It is hard to see how this situation will deescalate in the near future.

With numerous economic indicators now going into reverse, Hong Kong’s reputation as one of the world’s leading financial centers is under threat. It remains to be seen if Hong Kong’s leading law firms will be adversely affected by these market developments, but we see foreign firms concerned over their Hong Kong offices. Perhaps not surprisingly, there are rumors about legal work being shifted to Singapore.

**Singapore**

Over many years, Singapore has established a reputation for being one of the best places in the world in which to do business. And, in light of the ongoing upheavals in Hong Kong, we see the country becoming an even more important center for the Asian legal market and beyond. Not only is the country one of the most important jurisdictions for international arbitration, it is also a vital global hub for commodities trading.

**Australia**

Australia’s legal market performed well in 2019. Continued transactional activity and class actions have contributed to ongoing growth. Most notably, law firms have recently benefited from the Hayne Royal Commission investigation into the banking and financial services sector and The Royal Commission into Aged Care Quality and Safety. Even though the Hayne Royal Commission’s work is now complete, we anticipate that the findings of both commissions will continue to keep lawyers busy for several years.

**China**

Foreign law firms with offices in China are experiencing mixed results. The majority of foreign firms have small offices, and the economics for many remain a challenge. While some are having reasonable success, others are being cautious about expansion, and some have withdrawn from the country entirely.

One interesting development is that Chinese firms are growing faster than most foreign firms. Many of the most successful Chinese law practices have also adopted Western operational models, and have raised their lawyer compensation levels.
Global Presence: a Range of Approaches

For many law firms, the tendency for their clients to globalize their operations forces them to address a key strategic issue: should they follow their clients’ lead, and also globalize their offering?

Over the past few years, there has been a clear trend toward large law firms becoming more global. Here, many firms have pursued a “glocal” approach, combining cross-border strength with local depth. But this does not mean that all firms must operate in every legal market in which their clients operate. Latin America is a case in point: today, many US law firms act for Latin American clients without having any offices in the region. Acting for such clients in relation to their cross-border legal needs is often a viable, and profitable, option for US firms. Similarly, it is also possible to become a global market leader in specific legal specialties, despite having a limited global footprint—the success of many New York firms in relation to cross-border finance and M&A being an example of such a strategy.

When any firm decides to open an office in a new market, it faces a key choice: should it do so whole-heartedly, typically via a local merger or significant team hire, or more cautiously via the formation of smaller, representative offices? Here, experience tells us that, in order to operate profitably in a particular market, it is generally better to develop a credible local presence. That said, there are some locations where local practice restrictions make it almost impossible for firms to scale. In such scenarios, the firm’s office will mainly exist to funnel cross-border work back to the parent practice, while also performing a coordinating role with local “best friend” referral partners.
The Legal Market in 2020 and Beyond

We do not anticipate a recession to occur in 2020. We expect to see top-line growth in the range of 5 to 6 percent, with continued dispersion behind the industry averages. Looking ahead, we expect that the most successful firms will continue to expand and innovate—despite ongoing geopolitical and macroeconomic uncertainty and volatility, and a challenging talent market. For those firms, expansion will be closely aligned to the firm’s business strategy—more so than pursuing opportunistic growth.

While law firm revenue growth has been largely driven by rate increases for several years, we encourage firms to explore other ways of increasing revenue. The most successful firms we work with tell us they are focused on doing more with existing clients. They are increasing collaboration and cross-selling between offices and practices. Additionally, an increasing number of firms are experimenting with allied practices, including eDiscovery, consulting and temporary lawyer placement services.

In terms of lateral hires, firms are increasingly hiring lawyers who are better aligned with firm strategy. They are then focusing closely on how to leverage the client relationships that the new hires bring to the firm, and how they can help to expand the firm’s existing client relationships. And, as firms settle on their expansion plans, they are closely examining the profitability of their current practice mix. Additionally, the most successful firms are reviewing their leverage models to ensure they are as productive and profitable as possible. We believe this is a prudent approach to growth.

Where Will Growth Come From?

Practice area growth opportunities

In Citi’s 2019 Law Firm Leaders Survey, M&A/transactional work is viewed as the standout growth opportunity through 2021. Views on private equity-driven work remain mostly positive. However, some now fear that demand for this type of work may slow.

Litigation remains a major driver of legal work. However, many firms are concerned about its future growth prospects. More positively, they are largely optimistic about growth in white collar/regulatory investigations and bankruptcy/financial restructuring work. Firms have mixed views about the growth outlook for finance and capital markets, real estate and intellectual property work.

Industry sector growth opportunities

On an industry sector basis, law firm leaders regard the technology sector as being the most promising growth opportunity through 2021, particularly as this sector continues to diversify beyond its traditional Silicon Valley heartland. Other promising sectors for legal work include healthcare, life sciences, private equity and energy. Firms also see growth opportunities in pharmaceuticals, infrastructure and media. However, firms are less positive about future growth from manufacturing, automotive and retail-focused clients, and have mixed views about the prospects of the real estate sector. Financial services, while a major driver of legal work, remains an industry that creates challenges for law firms, particularly in relation to pricing pressure and data security-related requirements.

Geographic growth opportunities

In Citi’s 2019 Law Firm Leaders Survey, as Chart 2 illustrates, we see that the US will provide the greatest opportunities for growth over the next two years. In contrast, Asia and mainland Europe are regarded as more challenging markets.

The standout opportunity location will be New York. That said, there is intense competition for clients and talent in this city. Firms are also looking to Washington DC, largely driven by regulatory investigations and government relations work. Northern California is regarded as a key growth market in the coming years. Optimism toward this location is being driven by the continued growth of the technology industry itself, together with the increasing likelihood that the sector will become more heavily regulated. Texas is also viewed as a growth opportunity, driven by both energy and technology work—an example of the expanding market for technology work.

Outside the US, the standout growth opportunity remains London. This city was ranked as second only to New York in terms of growth opportunities. While some believe the London market faces challenges, they are far outnumbered by those who regard the city as a growth opportunity. London is now home to dozens of international law firms, as well as hundreds of indigenous practices. Competition for work and talent is therefore fierce. That said, Brexit will continue to create several years of advisory work for law firms. So long as London remains one of the world’s main centers for private equity firms and hedge funds, it is also likely that these industries will continue to fuel the city’s legal sector.
Consolidation: Laterals, Acquisitions and the Challenge of Mergers

Consolidation within the legal profession occurs through three main routes: lateral hires, firm acquisitions and mergers. While we expect to see an active lateral market and continued acquisitions in the near future, we doubt that the pace of new mergers will continue at the same rate as has occurred during the last few years.

We are often asked why mergers take place, and why certain mergers succeed. In our view, there are several factors that can facilitate—or inhibit—a successful merger. These factors are constant, irrespective of the merging firms’ size.

A merger must offer all participating firms the opportunity to do something different. For example, the combination may allow a firm to extend its geographic footprint, offer a new service, or improve the profitability of a legacy practice. The planned benefits of the proposed combination should be set out in a credible business plan at the start of the merger discussions. We do not believe that, in itself, headcount expansion should be regarded as a key benefit of any merger.

The challenges of the proposed combination should also be identified during the early stage of any merger discussions—it should be appreciated that not all partners and practices will benefit from the union. Particular attention should be paid to the risk of new client conflicts being created. This evaluation should start from the presumption that clients will not waive conflicts. Additionally, it should be appreciated that it will often take several months, if not years, to leverage new revenue from the consolidated firms’ client base—revenue projections on this point should not be unrealistic. Additionally, debt and unfunded pension plans can sometimes cause merger negotiations to fail.

To be successful, the leadership of the merging firms will need to be absolutely committed—this has not always been the case previously. It should be appreciated that the post-merger integration of the combining firms will be more complicated than the initial negotiations. This is especially true for cross-border mergers, which can be particularly challenging.
Developments in the Business Model

To capture future opportunities, and address the challenges ahead, we expect that firms will continue to develop more innovative service delivery models. They will continue to experiment with creative pricing options and become even more targeted in their business development efforts. Firms will also increasingly focus on improving client and practice profitability.

A more innovative service delivery model

With the growing competition from Big Four accounting firms and alternative lower cost service providers, we expect that law firms will focus even more so than before on delivering their services more efficiently. We already see firms promoting their alternative service delivery offerings, which typically focus on lower cost leverage, eDiscovery and litigation support, automated due diligence, project management, technology solutions and online subscription services. For firms which embrace this way of working, revenue is no longer solely derived from billable hours. We anticipate that revenue generated from solutions, as opposed to hours logged, will continue to grow as a proportion of overall firm revenue.

Given the limited resources available to law departments, we see a growing opportunity for firms to offer legal technology and process improvement services to their clients. Bringing a law firm’s technology solutions and best thinking on efficient service delivery to how law department clients operate embeds the firm within the client’s operations, strengthening the client relationship.

When it comes to legal technology, Chart 3 illustrates how the take-up of artificial intelligence (AI) based solutions has increased rapidly among those firms which responded to Citi’s 2019 Law Firm Leaders Survey.

Chart 3: Artificial Intelligence (AI) in 2019 vs. 2017

<table>
<thead>
<tr>
<th>Service Type</th>
<th>2017</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>eDiscovery Predictive Coding / Predictive Outcomes</td>
<td>67%  12%</td>
<td>80%  8%</td>
</tr>
<tr>
<td>Contract or Other Transactional Document Analysis / Due Diligence Review</td>
<td>71%  16%</td>
<td>7%  14%</td>
</tr>
<tr>
<td>Contract or Other Transactional Document Creation</td>
<td>18%  16%</td>
<td>4%  12%</td>
</tr>
<tr>
<td>Legal Research / Predictive Analytics</td>
<td>27%  15%</td>
<td>31%  12%</td>
</tr>
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</table>

More efficient collections

As part of their wider efforts to streamline their operations, we expect that firms will try to speed up their collection cycles. This is a reaction to the growing trend of clients delaying bill payment—often due to queries raised about the bills. In our view, the collection cycle can be shortened in two ways: firstly by converting unbilled time into invoices more quickly, and secondly by ensuring that bills created comply with clients’ requirements. Here, the trend toward firms employing specialist billing teams will continue. These teams review bills before they are sent to clients, thereby making it less likely that the bills will be challenged.

We also see firms using other levers to speed up the collection cycle, including accelerating distributions. To further improve collections, we suggest firms should undertake regular inventory reviews. “At risk” and aged inventory should be targeted, via both mid-year and end-of-year collections pushes.

Finally, we suggest that firms pay particular attention to improving collections from those clients who occupy the bottom third of the firm’s revenue. It is this revenue segment that tends to be the biggest drag on a firm’s overall performance.

More targeted business development

One obvious source of new opportunities is, of course, a firm’s current client basis. To generate greater revenue from this source, we see firms building more client-focused multi-disciplinary teams than ever before. Firms also tell us they are investing more in business development efforts, including bringing on more business development professionals. That said, the turnover rate of business development staff is very high and remains a challenge for many firms.

More focus on client and practice profitability

We expect to see firms focus even more rigorously on the profitability of clients, practices and individual partners. Firms tell us that they will be looking at “right sizing” less profitable practices. Curbng partners’ willingness to discount fees, or accept “rate leakage”, can also boost client and matter profitability.

More creative pricing

According to Citi’s 2019 Law Firm Leaders Survey, alternative fee arrangements (AFAs) remain a low proportion of firm revenue. In 2018, just 17.2 percent of law firm revenue came from AFAs—much lower than the 19.1 percent projected for 2018 in last year’s survey. Further, survey participants project that 17.8 percent of law firm revenue will be generated from AFAs in 2019—a rise of just 0.6 percent on last year’s result.
That said, there is wide dispersion in the adoption of AFAs among survey participants. One third of law firms reported that AFAs accounted for more than 20 percent of revenue, while a similar percentage said that AFAs accounted for less than 10 percent.

Going forward, 86 percent of survey participants anticipated that AFAs would increase by 2021, while 14 percent said they would remain about the same—no one predicted that AFA usage would fall during this timeframe. This finding is in line with research previously undertaken by Citi, which has consistently found that firms plan to make greater use of AFAs in the near future—even if they subsequently do not see an increase.

Arguably the main reason why AFA take up remains low is that they have not gained widespread support among clients. Law firms consistently tell us that, even when clients initially request an AFA, they often later revert to requesting a discounted hourly rate.

The challenge for firms is how to make AFAs profitable. In Citi’s 2019 Law Firm Leaders Survey, 48 percent of survey participants reported seeing AFAs have a positive effect on margins. While this is not yet a majority view, it is the highest rate of success we have seen to date. We attribute this shift in AFA profitability to firms becoming better at managing matters generally, encouraging adherence to budgets, better staffing decisions and more use of technology. Indeed, we believe that the rigor associated with AFAs will be beneficial for firms which adopt them. Enhanced rigor in relation to matter scoping and pricing often leads to firms receiving more work from those clients.

A different look at demand and pricing: matters versus hours

We have traditionally looked at demand as measured by total billable hours logged. Based on this measure, modest demand growth has been the industry norm, while rate increases have been the primary driver of revenue growth. There is another way to look at demand—based on the number of matters worked. On this measure, during 2010-18 for respondents to Citi’s 2019 Law Firm Leaders Survey (see Chart 4), we saw comparatively stronger growth in matters worked, at a compound annual growth rate (CAGR) of 2.4 percent, compared with a CAGR of 1.4 percent in the number of total billable hours logged. The net effect was that the average time spent on each matter declined by an average annual rate of 0.9 percent. Meanwhile, the price per matter increased by an average annual realized rate of 2.9 percent. This suggests that clients were happy to pay more for the right outcome, and were less concerned about the time spent to reach that outcome. It also suggests that the more efficient firms can become, the greater the opportunity to improve their margins.

### Chart 4: Demand and Pricing During 2010-18: Matters vs. Hours

<table>
<thead>
<tr>
<th>Billable Hour Demand and Pricing: 2010-18 CAGR</th>
</tr>
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<tbody>
<tr>
<td>Total Billable Hours Logged</td>
</tr>
<tr>
<td>-----------------------------</td>
</tr>
<tr>
<td>1.4%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Matter Demand and Pricing: 2010-18 CAGR</th>
</tr>
</thead>
<tbody>
<tr>
<td># of Matters</td>
</tr>
<tr>
<td>-------------</td>
</tr>
<tr>
<td>2.4%</td>
</tr>
</tbody>
</table>

Source: Citi Annual Survey and Citi Law Firm Leaders Survey

Calculations are based on a 2010-18 $ value of all timekeeper hours logged CAGR of 5.9% and 2010-18 realization CAGR of -0.6%.
Developments in the Leverage Model

Over the next few years, we anticipate further growth in leverage, and the increased adoption of alternative staffing models, with a particular emphasis on reducing the cost of leverage. The greater use of technology and—in particular—AI, will be an important part of this development, along with the employment of more junior associates, and contract and temporary lawyers. Quantifying these projections, Citi’s 2019 Law Firm Leaders Survey (illustrated in Chart 5) found that 84 percent planned to increase their associate numbers, 78 percent planned to increase their permanent lower cost lawyers, and a majority planned to increase their use of temporary/contract lawyers.

Beyond lawyer leverage, the majority of firms are maintaining their current levels of “other timekeepers”, such as eDiscovery personnel, specialist advisors, project managers, professional support lawyers, patent agents, technology professionals and law clerks. In addition, a significant minority—45 percent—plan to increase this part of their leverage.

The most notable trend among growth in other timekeepers is the increasing number of project managers in law firms. Just a few years ago, firms tended to focus on training partners and associates in project management skills, rather than hiring full time project managers. Now, we increasingly see clients who are willing to pay for this project management service in its own right, because it can help manage costs. Paid-for project management services therefore represent a growing revenue opportunity for law firms.

Chart 5: Projected Leverage Growth By Category: 2019–21

<table>
<thead>
<tr>
<th>Category</th>
<th>Decrease</th>
<th>Remain Flat</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Partners</td>
<td>24%</td>
<td>18%</td>
<td>58%</td>
</tr>
<tr>
<td>Counsel</td>
<td>17%</td>
<td>31%</td>
<td>52%</td>
</tr>
<tr>
<td>Of Counsel</td>
<td>10%</td>
<td>55%</td>
<td>35%</td>
</tr>
<tr>
<td>Associates</td>
<td>16%</td>
<td>84%</td>
<td>35%</td>
</tr>
<tr>
<td>Temp / Contract</td>
<td>6%</td>
<td>36%</td>
<td>58%</td>
</tr>
<tr>
<td>Permanent lower-cost</td>
<td>3%</td>
<td>61%</td>
<td>78%</td>
</tr>
<tr>
<td>Paralegals</td>
<td>12%</td>
<td>61%</td>
<td>27%</td>
</tr>
<tr>
<td>Other Timekeepers</td>
<td>55%</td>
<td></td>
<td>45%</td>
</tr>
</tbody>
</table>

Source: Citi Law Firm Leaders Survey
Preparing for the Next Recession

At the time of writing, Citi does not anticipate a recession in 2020. But, perhaps reflecting ongoing negative commentary in the legal press, our research suggests that some law firm leaders do not share that view. A small majority predict a recession will occur by 2020, with a larger majority predicting a recession by 2021. This suggests that law firm leaders may be talking themselves into a recession months—if not years—before one actually occurs.

Even if a recession is not on the horizon, we suggest that law firm leaders should learn lessons from the past and avoid the temptation to overreact. Evidence collected over many years tells us that recessions tend to have a modest impact on the legal sector. At worst, firms tend to experience modest falls in profits or revenue, typically by mid-to-low single digit amounts. Moreover, any fall in profits or revenue tend to be short-lived, lasting for less than two years. That said, firms which have a strong legal practice or industry sector focus tend to be more exposed during a recession, compared with their more balanced and diversified counterparts.

More positively, experience also tells us that firms are often able to increase their rates during a recession, albeit more modestly than before. Clients, under pressure to reduce their internal costs, also often outsource more of their legal work during this time. This offers firms an opportunity to win more client work, and further enhance their client relationships.

In terms of the practical steps that law firms can take to prepare for a downturn, we suggest that headcount levels in recession-sensitive practice areas should be kept under close review, with new investments focused on counter-cyclical practice areas. We know, for example, that transactional practices tend to contract during a recession, whereas litigation, and bankruptcy and financial restructuring work tends to increase. Unfortunately, because it is difficult to move partners between practice areas, it may be necessary to reduce partner headcount in recession-hit practice areas.

Headcount reductions are an important tool for law firms seeking to reduce their cost base during a recession. However, we would counsel against firms making excessive cuts to junior associate headcount, simply to ensure that partners maintain their own levels of compensation. Experience tells us that demand for junior to midlevel associates tends to rebound quickly after a recession. It is often disproportionately expensive to try to replace these associates following a downturn, due to rapid labor market tightening.

A more strategic approach to labor cost reduction is to examine the profitability of the firm’s leverage model at every level. Often, the least profitable fee earners will be the most senior. For this reason, firms should also avoid adopting headcount reduction strategies based on the “first in last out” principle.

In terms of cutting overhead expense, perhaps the biggest opportunity is to review real estate costs. Issues to be reviewed may include examining whether to move to lower cost offices, or reducing the amount of space required. As leases come up for renewal, we expect that firms will take the opportunity to review and reduce real estate costs.

During a recession, it is always tempting to cut overhead expenses deemed to be unnecessary—and the annual partners’ meeting is often an early casualty. We suggest that scrapping the annual partners’ meeting is often a false saving—such meeting can be an important morale boosting exercise, while also facilitating internal partner cross-selling. Rather than cancelling this meeting entirely, we instead suggest that it should be held in a low-cost location that is quickly accessible to most partners.

The most serious challenge facing law firm leaders in a recession is that of underperforming income and equity partners. Unfortunately, partner underperformance is often indulged by law firm leaders during the good times, thereby requiring more drastic corrective action when profits stall. This inconsistent approach to partner productivity can be avoided by reviewing partner performance on an annual basis, irrespective of the current economic situation. This approach may require strong leadership to implement but is ultimately vital to a firm’s ongoing success. Partners are less likely to defect from a firm if they see underperforming partners removed, and their own successes rewarded.
Trends in the Equity Partnership

We see a number of positive equity partnership trends ahead. First, a majority of firms responding to Citi’s 2019 Law Firm Leaders Survey—61 percent—said they planned to grow their equity partnerships in the next two years. In contrast, only 11 percent projected a reduction in equity partner headcount.

Laterals: a better bet than before?

We expect that firms are likely to grow their equity partner ranks via a mix of promotions and lateral hires. Firms continue to report higher success rates for promoted equity partners compared to laterals. That said, the second positive trend to emerge in recent years is the improved success rate of lateral hires.

In Citi’s 2019 Law Firm Leaders Survey, the proportion of lateral hires perceived as being successful or very successful during the past five years reached 63 percent—the highest figure since Citi began surveying firms on this issue.

The key reason for the improved lateral success rate is that firms are imposing even greater rigor on the lateral hiring process. Firms tell us that they are now aligning their hiring decisions more closely with the firm’s overall strategy, while also undertaking less opportunistic hiring. Due diligence efforts have improved. Additionally, firms are now taking a more proactive approach toward integrating their lateral partner hires. This includes creating dedicated integration teams, together with an enhanced senior leadership focus on the successful integration of new laterals.

Why do partners stay versus leave?

While bringing on top equity partner talent will continue to be an important part of the typical law firm growth strategy, firms also face an increased risk of losing their top talent to others. Indeed, in Citi’s 2019 Law Firm Leaders Survey, more than three quarters of respondents said their equity partners were now receiving more approaches to move laterally.

We often read about star lateral hires moving from one firm to another. However, we rarely read about partners who chose to stay. Following conversations with law firm leaders on this subject, we sought to quantify this stay-to-go ratio. Research conducted for Citi’s 2019 Law Firm Leaders Survey indicated that, for every partner who leaves a firm following an approach, an average of eight others chose to stay.

Why do many equity partners refuse advances from rival firms? Our research suggests that partners mainly stay with a firm because they like the firm’s culture. And, for many, the combination of culture and compensation is important. Many partners also recognize that the firm’s platform—the extent to which client relationships are embedded—represents an important contributing factor to their own success. Finally, a firm’s past—and projected—financial performance is also an important consideration.

The main reasons why partners leave do not always relate to compensation. Often, they will be looking for a better platform for their practice, or because of client conflicts. They may feel that a new firm can offer them a better cultural fit. We have also heard of situations where partners left a firm because they had been passed over for a leadership opportunity, or because they were offered a leadership opportunity at a new firm.

That said, with compensation being an important driver of both equity partner retention and departure, the message to law firm leaders is clear: while culture is important, retaining equity partner talent requires a firm to be highly profitable. Profit-focused equity partners tend not to remain at firms who do not share their ethos.
Conclusion

We believe that the law firm industry will continue to grow in 2020. We also expect to see continued dispersion, leading to further market consolidation. For many firms, the steps they are taking to do more with existing clients and broaden their client base, focus on growth practices, industries and regions, and introduce further efficiencies in the way they deliver legal services will go a long way to ensuring that 2020 is a successful year.

While we do not expect a recession in 2020, we also consider it prudent for law firms to plan for a future slowdown. 2020 presents an opportunity for firms to look closely at how they operate: including examining the expense base, improving the collection cycle, and scrutinizing the profitability of their practice mix. We further suggest that, at this phase of the economic cycle, firms should avoid putting “too many eggs in one basket”, or seeking to grow further, simply for growth’s sake.

We believe that in the event of a recession at some point, the legal profession will adjust to less favorable market conditions, just as it has done in the past.

We wish all of our readers a successful 2020.

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