PEER MONITOR | SPECIAL REPORT

REUTERS/Toru Hanai

Does Slower Rate Growth Increase Revenues?

A Peer Monitor Special Report

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It's a formula as basic as Economics 101 for any law firm: Gross Revenues = Hourly Rate x Hours Billed. Despite gains in popularity for fixed fee and other alternative fee arrangements, this remains the basic calculus behind the majority of law firm billings.

Deciding where to set rates can quickly become difficult, owing to the complex relationship between pricing and demand, which plays out influenced by factors such as price-demand elasticity – the inverse relationship between price and demand. For law firms, there are the additional dynamics of pricing negotiations that occur along the line from annual contracts to individual matters.

For decades, firms have often used annual rate increases as a reliable means of growing revenue. The typical philosophy could be summed up as "the firm needs to make more money, so let's bill more hours at higher rates."

At the mid-year point, we began to notice an interesting trend regarding rates. Thomson Reuters Peer Monitor®[1] data of large law firms suggests that firms with smaller rate increases may be experiencing better demand and revenue growth than firms pushing higher rate growth.

PRICING PRESSURE

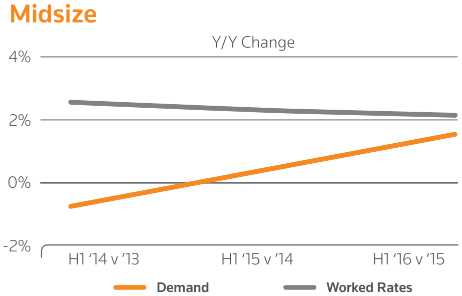
Rate growth has been slowing across the board for about a decade, owing to persistent pressure from clients seeking not only lower hourly rates, but greater use of alternative pricing arrangements such as fixed fees. Competition from non-law firm providers, such as legal process outsourcing, contract attorneys, and consulting firms, has only exacerbated these pressures.

After reaching a post-recession annual high of 3.4% in 2012, worked rate growth has been steadily slowing. Worked rates grew only 2.7% in 2015 – an all-time low mark.

SLOWER RATE GROWTH IS ASSOCIATED WITH MORE DEMAND

The suggestion that firms with slower rate growth may be experiencing greater success in this environment is evident looking at Peer Monitor data by market segment in rates and demand. (Rates covers agreed-to or contracted hourly rates set between firms and clients, not including subsequent discounts, write-offs, etc. Demand covers billable hours worked.)

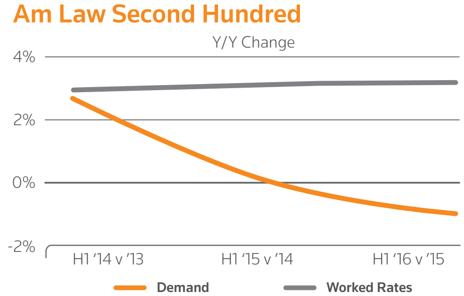
Midsize



Midsize firms have steadily trimmed their rate increases over the past three years. In the first half of 2014, midsize firms raised rates by an average of 2.5%, then by only 2.3% over the same period in 2015, and a mere 2.1% in 2016.

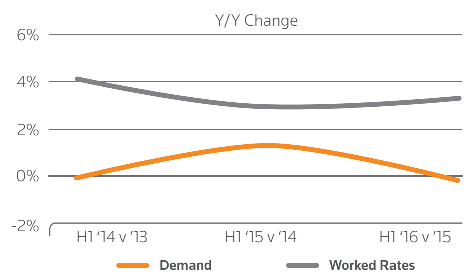
Meanwhile, demand climbed steadily year-over-year. After falling -0.8% in the first half of 2014, demand grew 0.4% in the same period in 2015, and grew 1.6% in 2016.

Am Law Second Hundred



Am Law Second Hundred firms, meanwhile, saw the opposite effect. Their worked rate growth climbed slightly, from an average of 2.9% in the first half of 2014 to 3.1% during the same period in both 2015 and 2016. As rate growth accelerated, demand slowed. Demand grew 1.7% in the first half of 2014, but fell 0.1% in the same period in 2015, and fell 1.0% in 2016.

Am Law 100



Am Law 100 is an even more interesting example. Average worked rate growth declined sharply from 4.1% in the first half of 2014 to 3.0% in the first half of 2015. Between those two time periods, demand grew – after falling 0.1% in the first half of 2014, demand rose 1.3% in the first half of 2015.

Then in the first half of this year, Am Law 100 year-over-year rate growth rebounded to 3.3%. Subsequently, however, demand slumped, falling 0.2%.

[1] Thomson Reuters Peer Monitor is an analysis of anonymized data from 151 large U.S.-based law firms.

SLOWER RATE GROWTH IS ASSOCIATED WITH STRONGER REVENUE

But demand alone doesn't tell the whole story. It still raises the question of whether the tradeoff between lower rate growth and increased demand has a net positive impact on revenues.

The data suggests that lower rate growth may be translating into stronger revenue growth. For this analysis, we examined fees worked (the product of billable hours worked multiplied by average rates) as a close proxy for revenues. Through the first six months of this year, firms with rate growth higher than 2.7% experienced an average increase in fees worked of 2.4%. Meanwhile, firms with rate growth less than 2.7% saw fees worked increase by an average of 3.2%.

> 2.7% = **2.4%**
HIGHER RATE GROWTH = FEES GROWTH

BUT

< 2.7% = **3.2%**
LOWER RATE GROWTH = FEES GROWTH

Further, the three-year analysis by market segment shows a similar association.

Midsize saw rate increases slow between the first six months of 2014, 2015, and 2016. Comparing fees worked between those time periods, however, there was a steady increase, rising 2.1% in the first half of 2014, 2.5% in 2015, and 3.8% in 2016.

Conversely, Am Law Second Hundred accelerated rate growth slightly over the last three years. Subsequently, growth in fees worked slowed from 5.9% in the first half of 2014 to 3.4% in 2015 and 2.2% in 2016.

Meanwhile, the teeter-totter rate increases for Am Law 100, which slowed in the first six months of 2014, grew in 2015, and then slowed again in 2016, saw opposite effects on revenues. As rate growth slowed, growth in fees worked jumped from 4.4% in the first six months of 2014 to 5.0% in 2015. When rate growth re-accelerated this year, however, growth in fees worked declined from 5.0% to 3.2%.

TIME TO RETHINK RATE STRATEGIES?

All of this is not to necessarily suggest that reducing rate growth is a one-size-fits-all strategy for every law firm. For any given firm, increasing or decreasing their rate growth may not necessarily produce a similar effect on demand and revenues.

But the data does suggest that basic market forces of price elasticity are in evidence, and may be alive and well in the law firm market. Firms that are willing to slow their rate increases are seeing higher average growth in demand and revenue than firms that are raising rates more aggressively.

In an environment of ever-increasing pricing pressure from clients, might it be time for firms to reexamine their rate strategies to reflect changing market dynamics?

Learn more at peermonitor.thomsonreuters.com

Have questions?
Contact Brent Turner, Manager for Peer Monitor
651-848-8715 or **brent.turner@tr.com.**