

PMI Holds Steady in Fourth Quarter

Expense Cuts Help Offset First Annual Drop in Demand Since 2013

The fourth quarter was a classic good news/bad news scenario: After three quarters of steadily increasing expenses, large law firms applied the brakes in the fourth quarter and reined in costs. And just in time. Demand slumped in the fourth quarter and rates pulled back slightly.

Demand declined steadily throughout 2016, turning negative at mid-year. In the fourth quarter, demand fell 1.4% – its third consecutive quarterly decline and the biggest drop since Q1 2013. That proved enough to pull full-year demand down 0.6% – the first annual decline in three years. It also marked the first year since 2010 to have three consecutive down quarters.

Rate growth pulled back slightly from a two-year high in the third quarter to 2.9% in the fourth quarter.

Productivity continued to drop, owing to falling demand and rising headcount growth.

But the drop in expenses helped hold the Thomson Reuters Peer Monitor® Economic Index (PMI)¹ at 48 for a second straight quarter.

DEMAND BY PRACTICE AREAS

Transactional practices were mixed.

Corporate work has been up for a remarkable 12 consecutive quarters, but just barely kept the streak alive in Q4, rising 0.2%. For the year, corporate was up 0.4%. Corporate work has largely been bolstered by M&A work, especially among Am Law 1-50 firms. M&A has also been positive for Am Law 51-100 and Second Hundred firms, although it makes up a smaller percentage of their work, and the overall corporate work has been down.

Real estate and Tax work both fell 2.1%, and were down 1.2% and 2.0% for the year, respectively.

Litigation was down 2.7% – its weakest performance since Q1 2013. For 2016 as a whole, litigation dropped 1.7% – the biggest demand drop in the last three years. Patent litigation fell 1.5% and finished the year down 2.5%.

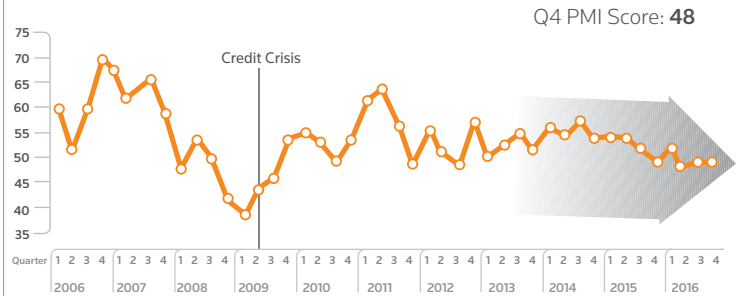
Patent prosecution, which had been up all year, inched down 0.1%, but was up 0.7% for the year.

Labor and employment was down 2.6% for the quarter and down 1.3% for the year. Bankruptcy fell 6.4%, ending the year down 3.5%.

PERFORMANCE BY MARKET SEGMENT

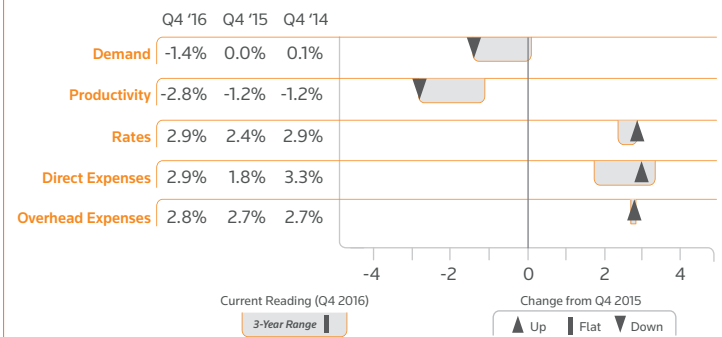
Amidst struggles in some of the other segments, Am Law 100 firms managed a respectable quarter and year. Demand was up 0.1% in Q4 – the only market segment to show an increase. However for the year, demand slipped 0.3%. After three consecutive quarters of worked rate growth of 3.3% or higher, rates rose 3.0% in Q4, leaving the 2016 rate growth at 3.3%. This was the strongest of any market segment and a marked improvement from the 2.7% rate growth in 2015.

PEER MONITOR ECONOMIC INDEX (PMI)

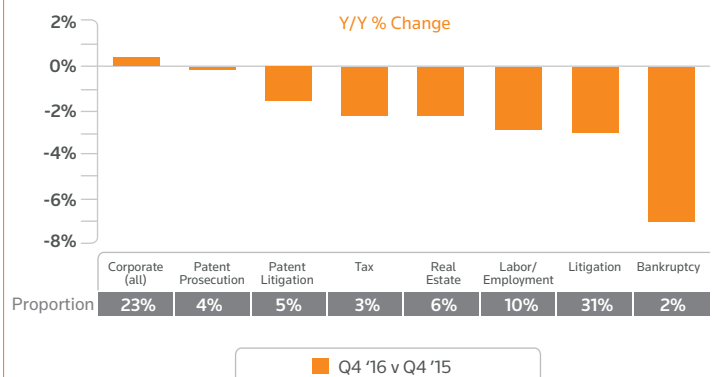


The PMI represents the relative rate of change among the major factors influencing law firm performance. These factors are tracked individually in the graph below.

PMI KEY FACTORS



DEMAND GROWTH BY PRACTICE



¹ The PMI is a composite index score, representing the quarter-over-quarter change in drivers of law firm profitability, including rates, demand, productivity and expenses. Positive factors driving firm profitability will produce a higher score. A score exceeding 65 generally indicates a healthy operating environment.

Midsized, despite a 1.6% drop in demand in Q4, managed a 0.1% gain in demand for the year – the only market segment to show positive growth. Relatively strong rate growth of 2.6% in Q4 helped raise rates 2.3% for the year, a slight improvement from the 2.2% growth in 2015.

Am Law Second Hundred significantly trailed the other segments in growth, falling 3.0% in Q4 and 1.7% for the year. Worked rate growth of 2.9% for the quarter resulted in 3.1% rate growth for the year – the only market segment not showing higher rate growth in 2016.

RATES

After working their way higher in Q2 and Q3, worked rate growth was 2.9% for the quarter and year – the latter was an improvement from the 2.7% rate growth seen in 2015.

Standard rates, meanwhile, were up 3.0%.

After a jump in Q3, collected realizations fell back to 82.5% – a mere one-tenth of a percentage point from its all-time low.

Cash collections were up only 0.9% during the quarter.

EXPENSES²

Expenses took an abrupt turn. After rising for three consecutive quarters to levels not seen for several years, firms sharply curtailed their expense growth in the fourth quarter.

Direct expenses rose only 2.9% – the slowest growth since Q1.

After setting an eight-year high last quarter, indirect expense growth dropped to 2.8% – the lowest mark of the year. While firms continued to spend in areas such as technology, recruiting, as well as marketing and business development, they have slowed spending growth in areas such as office expenses, libraries and outside services.

PRODUCTIVITY³

Productivity slumped 2.8% in the quarter – tying the worst mark of the year. For the full year, productivity fell 2.3% – the biggest drop since the depths of the 2008-09 recession.

Firms were squeezed by a perfect storm of slumping demand and rising headcount.

Headcount rose 1.6% in both the quarter and year – the latter representing the biggest annual jump in headcount since 2012.

It's notable that alone among the segments, Am Law Second Hundred firms did a remarkable job of slowing their headcount growth, even shrinking it -0.2% in the fourth quarter. For the year, it was up only 0.5% – a dramatic deceleration from 1.3% in 2015, and much lower than the other segments. But despite the effort, Am Law Second Hundred still finished only middle-of-the-pack in productivity because of declines in demand.

The attorney replenishment ratio⁴ pulled back slightly to 1.21 – although that is still near the highest end of the range seen over the last three years.

SPECIAL FOCUS

2016: YEAR OF TRENDS

2016 was marked by several distinct trends, some positive, some more worrisome.

In the former category, rates were generally stronger. After falling for most of the previous three years, rates rebounded slightly in 2016. While it has not yet made up for the declines, the return of any measure of pricing power is unquestionably a positive.

But while rates were inching upwards, demand spent most of 2016 slipping. After a relatively strong first quarter, demand eroded throughout the remainder of the year, falling for the first time since 2013.

Even as demand was slipping, firms generally accelerated their hiring, adding to headcount and direct expenses.

The combination resulted in a sharp drop in productivity, something the market has been struggling with for the past several years.

Aside from slightly healthier rates, many of the key indicators are trending in directions that will mean further challenges for law firm profitability if they should continue into 2017.

² Includes both direct expenses (salaries, fringe benefits and professional fees associated with billable timekeepers) and overhead expenses (all other nondirect expenses, including staff compensation, marketing, technology, occupancy, office expenses and research).

³ Productivity is defined as hours per attorney and represents the ratio of capacity to market demand.

⁴ Attorney replenishment is the ratio of new attorneys to the firm divided by those departing. A result greater than 1 indicates growing capacity, while a result less than 1 signals a contraction.

For more information on the PMI, and how Peer Monitor can help your firm successfully manage through today's economy, please contact Brent Turner at 651-848-8712 or brent.turner@thomsonreuters.com, or visit peermonitor.thomsonreuters.com.

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