PEER MONITOR INDEX

Q3 2014 EXECUTIVE REPORT - ISSUED 10.30.14

PMI Rises in Third Quarter

Most Practice Areas Stronger

The THOMSON REUTERS PEER MONITOR ECONOMIC INDEX (PMI)[1] gained 2 points to 57 in the third quarter – most major practice areas were stronger, including litigation. Demand[2] for large law firm services was up 1.2% – the third consecutive quarterly gain and the strongest jump since Q4 2012. Year-to-date demand is now up 0.9%.

Worked rate growth remained a consistent 3.1% – the same as the second quarter. Productivity was largely flat despite accelerating headcount growth. Direct expense growth is picking up, and still running ahead of demand.

Overall, it was a positive quarter, although persistently weak rate growth and rising headcount are holding back further gains.

Demand by Practice Areas

One of the most encouraging signs was the modest recovery in litigation. Litigation was down just 0.1% in the third quarter. Litigation has been consistently weak for several years, and this marked the best relative performance since Q2 2012. While litigation has shown some signs of improvement in 2014, the practice is still down 0.8% year-to-date.

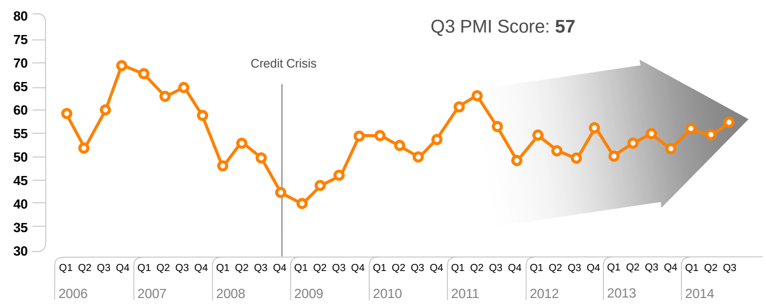
Meanwhile, transactional practices continue to be the engine of the market. Corporate work was up 3.2% for the quarter. Real estate work rose 2.8%. Tax work managed a 0.6% gain. All three of the transactional practices have been up every quarter so far this year.

Patent prosecution work has also been one of the stronger practices this year, and rose another 2.8% in the quarter. Labor and employment was up 1.1% – its strongest quarterly performance since Q3 2013. Bankruptcy was one of the few practices that declined in the quarter, falling 10.0%.

Performance by Market Segment

Am Law 100 and Second Hundred both had strong third quarters. Am Law Second Hundred had the strongest demand growth. Am Law 100 saw its first positive quarterly demand growth this year, accompanied by rate growth that was the highest of any market segment. Midsize firms continue to lag their larger peers, with flat demand and weak rate growth. Midsize firms have now had flat or declining demand growth for seven consecutive quarters.

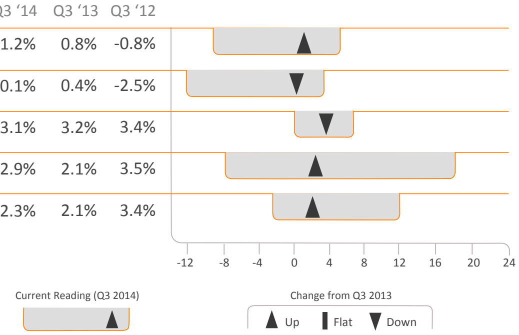
PEER MONITOR ECONOMIC INDEX (PMI)



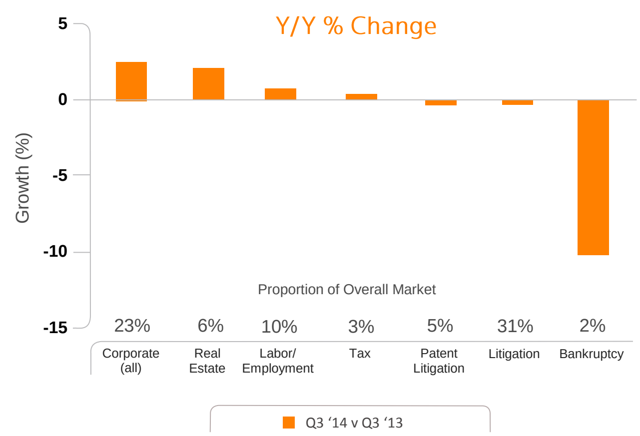
The PMI represents the relative rate of change among the major factors influencing law firm performance. These factors are tracked individually in the graph below.

PMI KEY FACTORS

	Q3 '14	Q3 '13	Q3 '12
Demand	1.2%	0.8%	-0.8%
Productivity	-0.1%	0.4%	-2.5%
Rates	3.1%	3.2%	3.4%
Direct Expenses	2.9%	2.1%	3.5%
Overhead Expenses	2.3%	2.1%	3.4%



DEMAND GROWTH BY PRACTICE: ALL SEGMENTS



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.*

2 *Demand is defined as the growth in billable hours.*

Rates

Third quarter worked rate growth (3.1%) remained the same as Q2 and slightly below the 3.2% average rate growth year-to-date. Standard rates, meanwhile, have largely been flat since the beginning of the year.

Collected realization rose slightly again this quarter to 83.7% – its highest level of the year.

Cash collections rose 2.7% compared with the same period a year ago, a smaller increase than seen in Q2.

Expenses[3]

Direct expense growth continues to accelerate as firms grow headcount. Direct expenses rose 2.9% in the third quarter – the highest rate in more than a year. Headcount was up 1.7% in the third quarter. Headcount growth has risen for the last four consecutive quarters, and is now at its highest level in nearly two years. The attorney replenishment ratio[4] was 1.1, about where it has been for the past few quarters.

Meanwhile, overhead expense growth continues to be stable, up 2.3% for the quarter.

Productivity[5]

Productivity was nearly flat for the quarter, down a scant 0.1%. Despite the improving demand picture, rising headcount continues to be a drag on productivity.

2014 Outlook

"Cautious optimism" has been the watchword for much of 2014. That optimism was rewarded in the third quarter. The market saw its third consecutive quarterly growth in demand, marking its highest growth rate in nearly two years, and year-to-date demand is now up nearly a full percentage point.

But the other side of the coin – caution – is still in order as well. Rate growth continues to be tepid, and productivity levels are negative-to-flat at best despite the improving demand picture as firms grow headcount.

As the market continues its dance of two-steps-forward-one-step-back, the overall trend is at least inching upwards – a welcome trend following the struggles of 2013. But recovery continues to be fragile. Demand-supply balance issues continue to hold back profitability.

However, transactional practices are providing a good underpinning for the market, and there are signs that even litigation may be improving.

3 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).

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.

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

For more information on the PMI, and how Peer Monitor can help your firm successfully manage through today's economy, please contact **Mike Abbott** at **651-848-4114** or (michael.abbott@thomsonreuters.com) or visit peermonitor.thomsonreuters.com.

Special Focus: Expenses – Good News, Bad News

Demand – and perhaps rates – are the first figures that many people focus on. And understandably, as they are prime indicators of how much business a firm is bringing in.

But the "back office" numbers, particularly expenses, play just as pivotal of a role in determining the financial health and profitability of a firm. And current trends in expense growth are mixed.

In 2012, firms did a commendable job of pulling back headcount growth, bringing supply into better balance with demand. But since Q3 2013, headcount growth has been steadily rising, reaching its highest level since Q4 2012. Firms continue to add headcount ahead of demand. In fact, in recent quarters, headcount growth has more than cancelled out growth in demand, dampening productivity and profitability.

But since reaching a near-term low of only 0.4% in mid-2013, headcount growth has now steadily increased for the last four quarters – the 1.7% growth in the third quarter marks its highest level in two years. Firms have been adding capacity in anticipation of growth that so far has not materialized to the degree that they had hoped.

At the same time, firms are doing an excellent job of controlling costs for overhead expenses. For the last six quarters, overhead expense growth has been in a narrow range of 2-2.5%. In fact, since 2011, overhead expenses have been remarkably stable, much more so than direct expenses, which have been seeing considerable volatility over the last three years.

While the relative stability is to some degree attributable to the long-term investments involved in overhead expenses (office leases, technology spending, etc.), at the same time, it is a credit to firms that they are demonstrating discipline and restraint in successfully managing overhead expenses.

In the "new normal" environment where robust demand growth is difficult, if not impossible, to attain, effectively managing costs is increasingly key to consistent profitability.

For further discussion on strategies for optimizing hiring plans, contact your Peer Monitor consultant.