PMI Holds Steady in First Quarter
Rising Demand Offset by Weak Rates, Productivity

The Thomson Reuters Peer Monitor Economic Index (PMI) held steady at 54 in the first quarter. While demand continued to show slow but steady growth, rate weakness and declining productivity are still evident as well. Demand for large law firm services rose 0.6% — the fifth consecutive quarterly gain, and a slight pickup from the previous quarter. In addition, gains were fairly broad-based: nearly all practice areas were up in the quarter.

Worked rate growth slowed to 2.8%. Productivity slid another 1.2% amidst rising headcount, while expense growth remained fairly steady.

So while the first quarter continued the positive momentum in demand, it also highlighted several challenges that still confront the market, including rates, headcount and productivity.

Demand by Practice Areas

Nearly all practice areas were up in the first quarter.

Transactional practices (as they have for the past several quarters) continued to lead the way. Corporate work rose 2.3%. Real estate was up 4.1% while tax work inched down 0.4%.

Litigation fell 0.3% — while an improvement over the 1.3% decline seen in Q4 2014, litigation continues its long-term downward slide. Patent litigation was down 1.4% for the first quarter.

Patent prosecution work, which was strong all last year, was up another 1.1%. Labor and employment gained 0.7%.

Bankruptcy was one of the few practices that fell during the quarter, dropping 7.0%.

Performance by Market Segment

Am Law 100 had the strongest demand (1.1%) and rate growth (3.2%). Am Law Second Hundred trailed in both demand (0.6%) and rates (3.0%). Midsize ended its long drought and saw its first quarterly growth (0.4%) in demand in more than two years.

Am Law Second Hundred has now seen positive demand growth for eight consecutive quarters, while Am Law 100 has managed to do so for the past three.

While Midsize was up in the first quarter, its demand growth (0.4%) and rates (2.1%) trailed the other market 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 billable hours.
Rates

Worked rate growth slipped to 2.8%, down from 2.9% in Q4 and 3.1% for all of 2014. The first quarter marked the slowest growth in worked rates since Q1 2011. Standard rate growth was sluggish as well with a 2.9% increase as compared to 3.1% for the period a year ago.

Collected realization dropped to 83.2%, tying an all-time low. Cash collections rose 3.7% compared with the same period a year ago – a 0.7% increase from Q4 2014.

The combination of weak rate growth and realization means rates are clearly becoming a cause for concern and a threat to profitability.

Expenses

Direct expenses were up 3.2%. Overhead expense growth was 2.6%. Both figures were down one-tenth of a percentage point from Q4 2014.

For the past two years, expense growth has been fairly steady in a range of roughly 2-3%. Firms appear to be keeping a close eye on costs, and this stability is helping them better plan for the current low growth environment.

However, despite the emphasis on cost controls, headcount continues to grow slightly faster than demand. Headcount rose 1.6% in the first quarter, which is slightly ahead of last year’s 1.4% growth. The attorney replenishment ratio\(^3\) was 1.1, in line with where it has been for the past few quarters.

Productivity

It’s becoming a recurring theme in recent quarters: demand rises but productivity does not. Productivity fell another 1.2% during the quarter – its sixth consecutive decline. The takeaway is straightforward: firms continue to add headcount in excess of demand. Headcount rose another 1.6% in the first quarter.

2015 Outlook

The market is starting the year by continuing its momentum from 2014. But while demand continues to grow at a steady pace – albeit slow – rate growth and productivity continue to show signs of slipping, eroding profitability.

Firms need to ensure that the pickup in demand doesn’t lead to complacency. Slowing worked rate growth, weak collected realization and declining productivity can easily wipe out revenue gains from modest growth in hours. Taking a holistic 360-degree view of market dynamics is critical. More than ever, it is essential for firms to step back and take a complete look at their financial metrics and where changes are taking place.

One of the keys is identifying financial vulnerabilities and pro-actively addressing them. For some firms, a revised rate strategy may be in order. For others, managing headcount flows to better match capacity against demand is what’s needed. Adjusting strategies to maximize strengths and correct weaknesses is critical at a time when gains increasingly require securing share within a flat-to-slightly-higher market.

\(^3\) 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.