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

All in all, it was a mixed picture for the market in the second quarter. The THOMSON REUTERS PEER MONITOR ECONOMIC INDEX (PMI) has now held steady for three consecutive quarters at 54.

Demand growth slowed in the second quarter while productivity continued to decline. Demand for large law firm services rose 0.3%. While that is the sixth consecutive quarterly gain, it is the second weakest gain throughout that span, and is down from the 0.6% gain seen in Q1. Year-to-date, demand is up 0.5%.

Worked rate growth grew slightly to 2.9%. Productivity fell 0.9% amidst rising headcount, while expense growth declined slightly.

Demand by Practice Areas

The major practice areas reflected the usual pattern seen over much of the last two years, with growth in transactional practices offsetting a decline in litigation.

Among transactionals, corporate work was up 1.9%, and is up 2.1% year-to-date. Real estate rose 4.0%, and is up 4.1% for the year. Tax work, however, declined for the second consecutive quarter, falling 1.0%, pulling it down 0.7% year-to-date.

Litigation was down 0.7% and is down 0.5% year-to-date. Patent litigation was down 2.6% in the second quarter, and is down 0.7% year-to-date.

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Performance by Market Segment

The Am Law 100 had the strongest demand growth (1.5%) and saw its fifth consecutive quarterly gain. In fact, the Am Law 100 had the strongest growth of any segment in both Q1 and Q2 and is up 1.3% year-to-date.

The Midsize was up 0.5% and is up 0.4% year-to-date. The Am Law Second Hundred was the only segment to show a decline in demand for Q2, down 0.4%, but is still up 0.1% year-to-date.

The Am Law Second Hundred had the highest rate growth – up 3.2%, and is up 3.1% year-to-date. The Am Law 100 was up 2.8% for the quarter, and is up 3.0% for the year. Midsize rate growth continues to trail the other segments, up 2.5% for the quarter and up 2.3% year-to-date.

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

Q2 ‘15 Q2 ‘14 Q2 ‘13
Demand 0.3% 0.5% 0.0%
Productivity -0.9% -0.8% -0.7%
Rates 2.8% 3.1% 3.2%
Direct Expenses 2.4% 2.2% 1.9%
Overhead Expenses 2.4% 2.4% 2.4%

PMI TABLE

Y/Y % Change

Real Estate Corporate (all) Litigation Bankruptcy Tax Labor/ Employment Patent Litigation
6% 23% 31% 2% 3% 10% 5%

Q2 ’15 v Q2 ’14

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.

Demand is defined as billable hours.

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Rates

Worked rate growth was up 2.9% in the quarter, up slightly from Q1, and is up 2.9% year-to-date. Standard rates, meanwhile, were up 2.9% in Q2.

Collected realization continued to bump along the bottom near all-time lows at 83.3% in Q2. Cash collections, on the other hand, rose a strong 4.4% compared with the same period a year ago.

Expenses

Direct and overhead expenses were both up 2.4%. Both figures have fallen for two consecutive quarters.

Direct expenses showed the slowest growth in four quarters. Headcount rose 1.0%, a marked deceleration from the 1.4% growth seen in Q1, as firms try to bring supply into better balance with demand. The attorney replenishment ratio was 1.2, a slight increase from what was seen for most of 2014.

Firms continue to maintain consistent cost discipline — however, at a level where expenses continue to grow at a pace that is hindering growth in profitability.

Productivity

Productivity fell 0.9% in the second quarter. While an improvement from the 1.2% decline seen in Q1, it marked the seventh consecutive quarterly decline. Firms trimmed their headcount growth, but continue to add positions faster than current demand warrants.

Half Full or Half Empty?

The market continues to plod along — and whether the recent trends represent reasons to cheer or not is a matter of perspective. This tug-of-war is reflected in the fact that the PMI has not budged so far this year.

The good: the market is finally showing consistent demand growth, up for six consecutive quarters — the longest stretch since before the 2008-2009 financial crisis.

The not so good: that growth is barely treading water above the positive line, averaging a meager 0.5% over those six quarters. Additionally, rate growth is weakening and headcount continues to grow faster than demand, putting pressure on profitability.

Positive demand growth — no matter how thin — is undoubtedly preferable to retrenchment, particularly after the struggles of the past several years (including a brief dip as recently as 2013).

But there is clearly much work that remains to be done if the industry is to return to broad, sustained growth. PMI data continues to show that growth is uneven — some firms are showing robust growth in hours, rates or both, while others are struggling to avoid declining numbers. In addition, many firms that were market leaders last year are falling back towards the pack, while others are taking their place at the top. This jockeying for market share and leadership is likely to continue into the foreseeable future.

And while expense growth has been fairly well contained recently, firms need to look at their spend more strategically and make hard choices on where to make investments that can pay off in better growth or productivity, whether in marketing, technology or elsewhere.

Strategy, vision and execution may make all the difference in a market that is still showing a pulse, albeit one that is steady but weak.

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.

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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.