

# PEER MONITOR INDEX

## PMI Declines in Fourth Quarter Slowing Rate Growth Reaches Alarming Levels

2015 was, in many ways, a repeat of 2014: a decently strong start to the year followed by fairly steady deterioration across the board in demand, rates and productivity as the year wore on. The difference is, because 2015 was starting from a weaker base, by the end of the year, demand, rates and productivity all finished well below the levels of a year ago.

Because all three key indicators turned in poor performances in what is traditionally one of the stronger quarters, the THOMSON REUTERS PEER MONITOR ECONOMIC INDEX (PMI)<sup>1</sup>, dropped two more points in the fourth quarter to 50.

Demand for large law firm services was flat for the quarter, breaking a string of seven consecutive quarterly gains – the longest winning stretch since the recession. For the year, demand was up only 0.3%, compared with 0.7% in 2014.

Meanwhile, the slide in worked rate growth continues unabated and is reaching troubling levels – rates rose only 2.4% in the quarter, the lowest since Q1 2011.

The drop in productivity accelerated slightly to 1.2%, bringing the decline for the full year to 1.1%, while expense growth slowed slightly.

## Demand by Practice Areas

Another familiar theme – growth in transactional practices offsetting declines in litigation – also carried over from 2014, but with a slight twist within litigation.

Transactional practices were again the growth engine of the market, especially corporate work, M&A and real estate. Corporate work was up 1.9% in Q4 and 2.2% for the full year. Real estate gained 2.5% in the quarter and 3.6% for the year. Tax work declined 0.3% in the fourth quarter and finished down 0.1% for the year.

Litigation declined 2.2% in Q4 and was down 1.0% for the year – its fifth consecutive yearly decline. However, the overall drop for the both quarter and year was entirely accounted for by Am Law Second Hundred, which was down a sharp 6.7% in Q4 and 3.9% for the year.

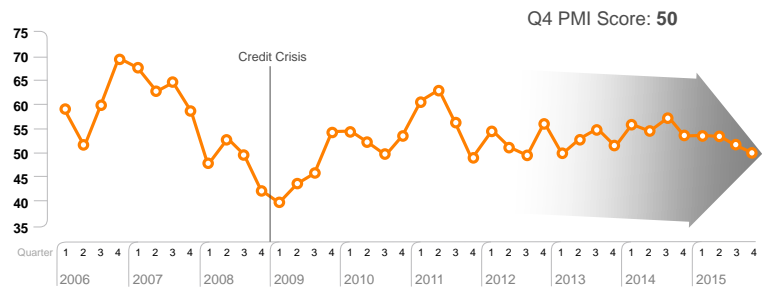
Litigation performance for the Am Law 100 and Midsize segments managed to finish 2015 basically flat for the year, despite fourth quarter contractions for both. This is a marked turnaround from 2014, when Am Law Second Hundred was positive for litigation, and both Am Law 100 and Midsize declined.

Demand for patent litigation work was down a sharp 4.5% in the fourth quarter, down 2.3% for the year.

Helping to offset declining patent litigation demand, patent prosecution has been a consistently strong performer and rose every quarter in 2015, gaining another 3.8% in the fourth quarter and 2.3% for the year.

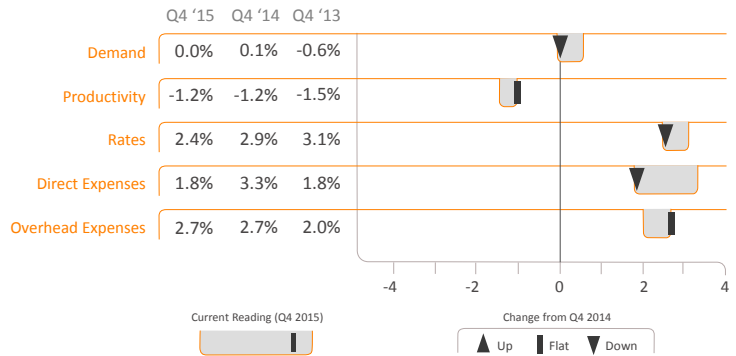
After rising in the first quarter, labor and employment fell for the next three quarters, including dropping 0.8% in the fourth quarter, finishing down 1.6% for the year.

### PEER MONITOR ECONOMIC INDEX (PMI)

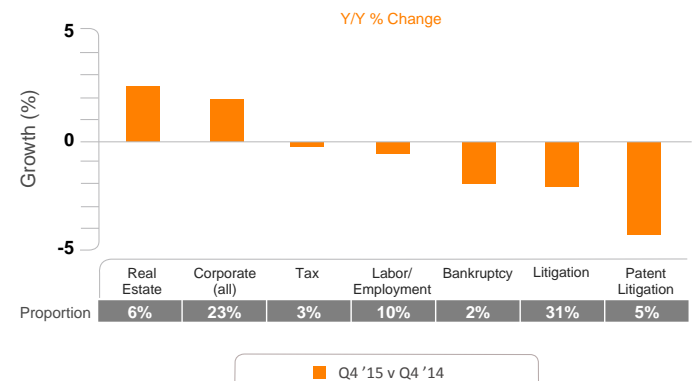


The PMI represents the relative rate of change among the major factors influencing law firm performance. These factors are tracked individually in the graph below.

### PMI KEY FACTORS



### DEMAND GROWTH BY PRACTICE



<sup>1</sup> 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.

## Performance by Market Segment

A rather pronounced reversal of fortune took place in 2015. Am Law Second Hundred was the poorest performing market segment – after showing the best segment performance in 2014 and 2013.

In contrast, Am Law 100 was the clear market leader for 2015, showing the highest demand growth each quarter. Demand was up another 1.9% in Q4, bringing its demand growth for the year to 1.7%. Meanwhile, Midsize saw its first annual growth since 2012, gaining 0.4% for the year following a 0.7% rise in the fourth quarter.

Am Law 100 and Midsize saw fairly consistent growth throughout the year. But Am Law Second Hundred demand deteriorated each quarter, dragging down the market averages, particularly in the last few months of the year.

## Rates

Slumping rate growth was the most alarming trend seen in the fourth quarter.

After slowing by three-tenths of a percent in Q3, worked rate growth fell another two-tenths in Q4 to a weak 2.4%. In other words, law firms lost half a percentage point in pricing power in just the last six months.

From 2011-2014, rates were in tight range from 3.0-3.4%. This year, rates broke out of that range, with worked rates growing only 2.7% for the year, although at times during the year rate growth slumped as low as 2.0%.

Standard rates, meanwhile, were up only 2.3% in Q4, down from 2.8% in Q3.

Collected realization showed some signs of stabilizing in 2015, however, the bad news is that it is doing so at record low levels of 82.9% for the last two quarters.

Cash collections were up only 3.5% compared with the same period a year ago. That's down from 3.9% seen in Q4 of 2014. However, Q4 cash collections were particularly strong for Am Law 100, which was up 5.7%.

## Expenses<sup>2</sup>

Direct expense growth slowed significantly in the fourth quarter, rising only 1.8%. That's the slowest growth rate in two years. Much of the slowing was attributable to the Am Law Second Hundred, where direct expense growth slowed dramatically to just 1.3% from 3.8% in 2014, as well as the vivid slowed growth rate for the Midsize which experienced only 0.5% growth this year. In contrast, Am Law 100 direct expenses slowed only slightly to 4.0%.

Headcount rose 1.2% in the fourth quarter. The attorney replenishment ratio<sup>3</sup> remained at 1.2, where it had been throughout the year, with replenishment of equity and non-equity partners remaining below 1.0 while associates maintain 1.3.

Meanwhile, overhead expenses accelerated slightly in the fourth quarter, rising 2.7%, up from 2.5% the previous quarter.

## Productivity<sup>4</sup>

While productivity has been dropping for the last two years, the decline accelerated in 2015. In the fourth quarter, productivity fell 1.2%. For the year, productivity was down 1.1%, compared with 0.6% for 2014 and hours worked per lawyer has now reached its lowest level in more than three years.

<sup>2</sup> 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).

<sup>3</sup> 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.

<sup>4</sup> Productivity is defined as hours worked per attorney and represents the ratio of capacity to market demand.

Headcount growth slowed only slightly in 2015, coming in at 1.3% for the year, compared with 1.4% in 2014. But with slowing demand growth, the gap between capacity and demand expanded.

## A Year with Little Cheer

An argument could be made that any year that shows positive demand growth is a good one. If that were the sole criteria, 2015 would qualify.

But the bigger picture is that the final numbers for demand, rates and productivity were all weaker than they were a year earlier. The overall impact of these figures is a clear slowdown in the market. Firms are seeing slowing demand for their services, while pricing power is weakening, and they are failing to properly balance capacity. The result is a less than sanguine outlook for firm growth and profitability, particularly in certain market segments.

Firms are running out of levers to pull to improve their bottom line. Rate hikes are not an option in what has become a buyers' market. While there may be some room to better right-size attorney headcount, overhead expenses are already operating at lean levels that leave little margin outside of areas that are essential for business development.

New strategies, such as different business models, rate strategies and staffing models need to be strongly considered in order to find new avenues of growth and profitability in an increasingly challenging market environment.

*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](mailto:michael.abbott@thomsonreuters.com) or visit [peermonitor.thomsonreuters.com](http://peermonitor.thomsonreuters.com).*

## Special Focus: The Performance Gap Widens – By the Numbers

“Unforgiving” may be one way to describe recent market conditions. 2015 was a challenging year for many firms. But the market is severely punishing those firms that underperform.

Firms that experienced positive demand growth in 2015 saw an average increase of 4.5%. One in five firms had growth of 5% or greater. But firms that experienced negative demand growth saw their average demand drop by a sharp 6.0%. Firms whose demand decreased by more than 5% moved from 16% in 2014 to 22% in 2015.

Particular woes befell the very bottom-performing firms. The percentage of firms experiencing a drop in demand of 10% or greater nearly doubled from 4% in 2014 to 7% in 2015.

This pattern suggests that while better-performing firms managed to somewhat hold their own in 2015, they did so largely by taking away market share from firms that were performing poorly or otherwise vulnerable. As the overall market for large law firm services becomes increasingly flat, gains by top firms are gotten by siphoning market share.

And the gap between top-performing and bottom-performing firms continues to widen as the fight intensifies for share in a zero-sum market.

For further discussion on strategies, contact your Peer Monitor consultant.

