PEER MONITOR INDEX

Q1 2016 EXECUTIVE REPORT - ISSUED 05.02.16

PMI Rises in First Quarter

Highest Q1 Demand Growth in Four Years

The first quarter gave the large law firm market much to be pleased with, as it brought improved demand and rate growth compared with the end of last year.

With the improvement in the key indicators, the THOMSON REUTERS PEER MONITOR ECONOMIC INDEX (PMI)[1] rose 2 points to 52, the first increase in the PMI since Q3 2014.

Demand rose 1.2%. While not spectacular growth by any means, it still marked the strongest Q1 demand growth since 2012. Rate growth rebounded slightly from a poor Q4 2015 performance. However, collected realization took an alarming drop.

While productivity declined, the 1.0% drop in Q1 was the smallest decline in the last three quarters. Expense growth accelerated slightly as firms added more headcount and overhead costs.

Demand by Practice Areas

While it has been a persistent drag of the market for the last five years, litigation is showing some signs of improvement. Litigation declined 0.4% in the first quarter. Even though this was the fourteenth consecutive quarterly decline, it was the smallest decline over the last three quarters. And the decline was entirely attributable to poor performance by Am Law Second Hundred firms.

Am Law 100 litigation work rose 0.9% in the quarter, while Midsize was up an even stronger 1.7%. Meanwhile, Am Law Second Hundred saw litigation decline 2.8%. This indicates that while overall litigation numbers are still declining, we are seeing a long-awaited return to growth in litigation work from many firms.

Meanwhile, transactional practices continue to move ahead. Corporate work was up 0.8%. Real estate rose 1.5%. Tax work, however, declined 0.4%.

Patent prosecution, which has been another consistent strong performer recently, gained another 1.3% in the first quarter. Labor and employment was down 0.6%, its fourth consecutive quarterly decline. Bankruptcy dropped 4.1% for the quarter.

Performance by Market Segment

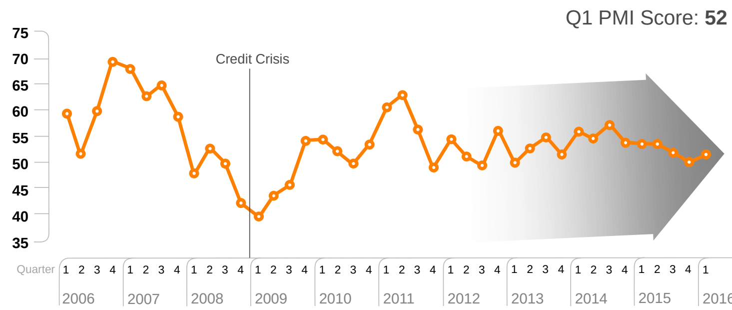
Midsize firms had the strongest demand, up 2.0%, while Am Law 100 rose 0.7%. Just as was the case for most of 2015, Am Law Second Hundred firms trailed again in the first quarter, falling 0.2% – the only market segment to show a drop in demand. As noted above, much of the Am Law Second Hundred's poor first quarter performance was attributable to weak demand for litigation work.

Rates

The market showed slightly better rate growth in the first quarter. Worked rates rose 2.7% – while that is still low growth by historical standards, it was a welcome improvement from the abysmal performance in the fourth quarter, where rates grew only 2.4%.

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.*

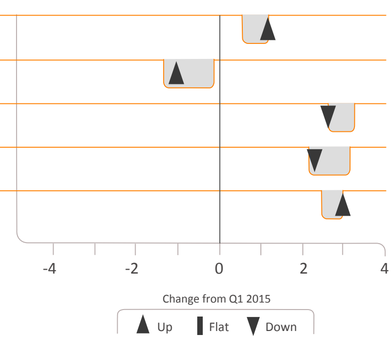
PEER MONITOR ECONOMIC INDEX (PMI)



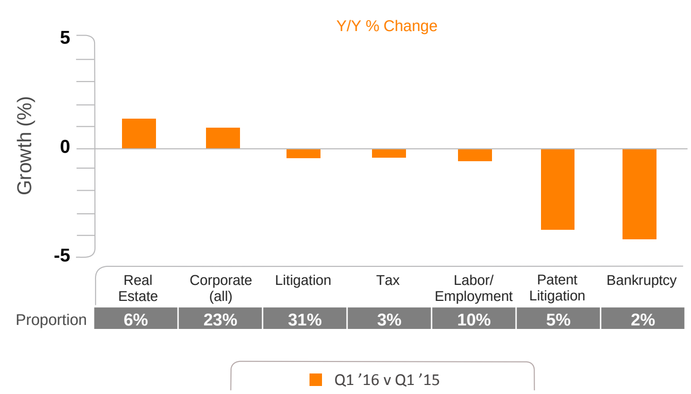
The PMI represents the relative rate of change among the major factors influencing law firm performance. These factors are tracked individually in the graph below.

PMI KEY FACTORS

	Q1 '16	Q1 '15	Q1 '14
Demand	1.2%	0.6%	0.9%
Productivity	-1.0%	-1.2%	-0.2%
Rates	2.7%	2.8%	3.4%
Direct Expenses	2.3%	3.2%	2.2%
Overhead Expenses	3.0%	2.6%	2.5%



DEMAND GROWTH BY PRACTICE



The worked rate growth in the first quarter still only matches the 2.7% seen for all of 2015, and firms historically aggressively raise rates in the first quarter to test their pricing power. So it remains to be seen whether the improvement in rates will carry through as the year wears on. Standard rates, meanwhile, were up 2.5%, up slightly from 2.3% in Q4.

After showing some recent signs of stabilizing, collected realization took a sudden and sharp drop in the first quarter. For most of the past two years, collection rates have hovered around the 83% mark. But in Q1, collected realization plummeted to 82.2%. Not only is this a new historical low, it was the largest quarterly drop in more than three years.

Cash collections were up 4.0% compared with the same period a year ago. That's a marked improvement from the 3.1% gain in the first quarter last year. However, the improvement was entirely driven by the Midsize segment, which saw cash collections rise 5.3%, a sizeable gain from the previous year. Both Am Law 100 and Second Hundred saw much smaller cash collections gains; Am Law Second Hundred firms were up a mere 0.9% in Q1.

Expenses[2]

After slowing in the fourth quarter, direct expense growth picked up slightly in the first quarter, rising 2.3%. However, this is well below the 3.2% growth rate seen the first quarter a year ago.

Headcount rose 1.6% in the first quarter, an increase over previous quarters. The attorney replenishment ratio[3] remained at 1.2, where it has been for the past several quarters.

Meanwhile, overhead expenses accelerated slightly in the first quarter, rising 3.0%. While this marks the highest overhead cost growth rate seen in the last three years, it is only slightly above the fairly tight 2.0-2.7% range seen during that period, indicating that overhead expenses are still under control, at least for the time being.

Productivity[4]

Productivity fell 1.0% in the quarter. While that is the tenth consecutive quarterly decline, it was the smallest decline over the last three quarters.

While headcount growth accelerated, the stronger demand growth helped to keep the productivity decline in check this quarter.

A Strong First Quarter

The market showed several encouraging signs in the first quarter. Demand growth was stronger, rate growth has stabilized somewhat, and productivity trended slightly better (although it is still negative).

None of this is to suggest that the road ahead is easy. Much like the overall economy, while the overall picture is improving, the market is somewhat fragile and several potential pitfalls could still derail the current flow of good news.

Rates remain weak, and together with the resumption of the decline in realizations, profits continue to be under pressure.

Nevertheless, the first quarter was largely positive. The market weathered the concerns early in the year about a global economic slowdown and potential recession. While such performance may induce sighs of relief, it may be prudent for firms to view the uptick as an opportunity for change, rather than a sign that the market has turned any sort of a corner.

Issues such as unbundling and disintermediation of legal services through alternative providers such as LPOs, and pricing pressures such as alternative fee arrangements still threaten to erode demand and rates for legal services. While conditions showed signs of improvement in the first quarter, long-term prospects for significant growth remain iffy at best. Firms need to continually evaluate innovative strategies, business models and technologies to prepare themselves for a fast-changing 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***
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Special Focus: Fast Growing (and Fast Shrinking) Firms

While the large law firm market continues to work its way forward, some firms are breaking away from the pack – some in a good way and some in a bad way.

At the head of the pack, we are seeing some firms sharply accelerating their growth. A year ago at this time, 8 percent of firms were experiencing demand growth above 10%. In the first quarter this year, that number had risen to 14 percent of firms showing growth of 10% or higher. This indicates that some firms are seeing strong traction with their business development and client retention strategies and gaining very strong growth.

But while some firms are breaking away from the pack, at the opposite end of the scale, more firms are falling out of the pack. We are seeing a drop-off in demand at the lowest performing firms. The percentage of firms seeing declines in demand of 10% or more has risen from 5 percent of firms last year, to 8 percent of firms in Q1 2016.

Overall market demand is still weak enough where, to a large extent, it is still a zero-sum game: the gains of higher-performing firms are largely achieved by taking share of business from under-performing firms.

With avenues for growth limited, competition for business appears to be sharpening.

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

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 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.

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

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