PEER MONITOR INDEX

Q2 2016 EXECUTIVE REPORT - ISSUED 08.01.16

PMI Slumps in Second Quarter

Demand Drops for First Time Since 2013

After an encouraging first quarter, the market was blindsided in the second quarter. A drop in demand across nearly all practices took the lift out from under the market's wings. A slight increase in worked rates was not nearly enough to make up for the shortfall in demand. Meanwhile, rising headcount and overhead expenses, and falling productivity added up to a near-perfect storm.

With nearly all of the key performance indicators displaying negative trends, the THOMSON REUTERS PEER MONITOR ECONOMIC INDEX (PMI)[1] fell 4 points to 48, the largest quarterly drop in the PMI since Q1 2013.

After a remarkable run of positive quarters for demand growth that began all the way back in Q1 of 2014, demand pulled back 0.9% in the second quarter. It was the biggest quarterly drop in more than three years.

Rates managed a slight improvement, as worked rate growth was 2.9% compared with 2.7% in the first quarter.

Expenses climbed for both direct and overhead costs, placing additional pressure on profitability. And the continuing drop in productivity accelerated as headcount growth rose.

Demand by Practice Areas

Transactional practices, which have largely been a bellwether for the market, turned in a mixed-to-weak performance. Corporate work was largely flat, up barely 0.1%. Year-to-date, it remains up 0.5%. Real estate and tax work, however, both retreated and are now negative year-to-date. Real estate was down 2.3% and is now down 0.4% year-to-date. Tax work declined 3.4% and is down 1.9% year-to-date.

Litigation, which had been showing some signs of improvement of late, was down another 1.8%. Excluding a similar decline in the fourth quarter of last year, it was the biggest quarterly drop since Q1 2013. Litigation remains down 1.1% year-to-date.

Patent prosecution managed to continue its string of recent positive performance, gaining another 0.2% in the quarter, and is up 0.8% year-to-date. Labor and employment was down 0.3%, its fifth consecutive quarterly decline, and is down 0.4% year-to-date. Bankruptcy dropped 1.8% and is down 2.9% year-to-date.

Performance by Market Segment

While overall market demand dropped in the second quarter, Midsize firms were largely unaffected. Demand for the segment rose 1.1%, and is still up 1.6% year-to-date. In contrast, Am Law 100 fell 1.0% in the quarter and is now down 0.2% year-to-date, while Am Law Second Hundred dropped 1.8% and is down 1.0% year-to-date.

Midsize even managed a surprisingly good quarter in litigation, up 1.6% both for the quarter and year-to-date.

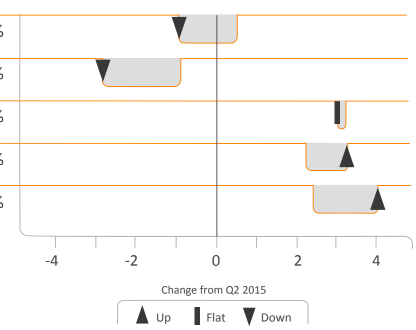
1 *The PMI is a composite index score, representing the quarter-over-quarter change in drivers of law firm profitability, including rates, demand, productivity and expenses. Positive factors driving firm profitability will produce a higher score. A score exceeding 65 generally indicates a healthy operating environment.*

PEER MONITOR ECONOMIC INDEX (PMI)

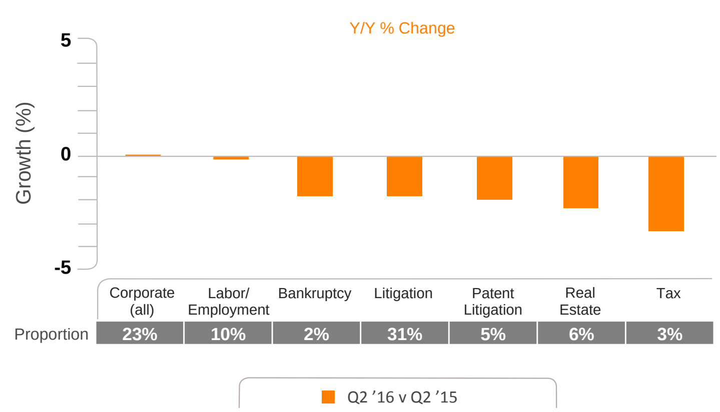
The PMI represents the relative rate of change among the major factors influencing law firm performance. These factors are tracked individually in the graph below.

PMI KEY FACTORS

	Q2 '16	Q2 '15	Q2 '14
Demand	-0.9%	0.3%	0.5%
Productivity	-2.8%	-0.9%	-0.8%
Rates	2.9%	2.9%	3.1%
Direct Expenses	3.2%	2.4%	2.2%
Overhead Expenses	4.0%	2.4%	2.4%



DEMAND GROWTH BY PRACTICE



As pointed out earlier, transactional practices were down pretty much across the board in the second quarter, but the downturn was particularly pronounced in Am Law Second Hundred, which was down in all three practices (corporate, real estate and tax). Am Law 100 is still seeing a slight pocket of strength in corporate work, which was up 0.6% for the quarter and is up 1.2% year-to-date. Midsize, meanwhile, saw a modest gain in real estate, up 2.6% and still up a strong 4.2% year-to-date.

Rates

Worked rates improved for a second consecutive quarter, up 2.9%. Rate growth of 2.8% year-to-date is now slightly higher than the 2.7% seen for all of 2015.

Standard rates, meanwhile, were up 3.1%.

Collected realization ticked upwards slightly to 82.4% in Q2 after hitting an all-time low in Q1.

Cash collections were up only 1.9%, compared with 4.0% in the first quarter. Cash collections were particularly weak for Am Law Second Hundred firms, up only 0.8%.

Expenses[2]

Both direct and overhead expenses have been climbing steadily this year. After reaching a multi-year low in the fourth quarter, direct expense growth reached 3.2% in the second quarter.

Overhead expenses, meanwhile, grew 4.0% -- the highest growth rate since 2008. Much of that was accounted for by growth in staff compensation and technology spending. Recruiting expenses, while not a significant proportion of overall overhead spending, spiked higher in the second quarter as firms increased their recruiting and hiring efforts.

Productivity[4]

Productivity fell sharply, down 2.8%. While productivity has been falling steadily for several years, this was the biggest drop in more than three years.

Productivity suffered from a double-whammy in the second quarter from falling demand and rising headcount. Headcount growth has been rising since the fourth quarter of last year, and was up 1.7% this quarter. Firms haven't had a higher headcount growth rate since Q2 of 2012. The attorney replenishment ratio rose to 1.26 -- its highest mark in three years – a further reflection of the accelerated pace of hiring.

After a modestly strong first quarter, firms may have stepped up their hiring in anticipation of further gains. Not only did those gains fail to materialize, but the slump in demand in the second quarter left firms with significantly greater capacity than warranted by demand.

In short, firms have been consistently growing headcount for a considerable period of time beyond what is justified by demand, and that gap is now growing wider. Firms may need to reevaluate their staffing levels and hiring plans to avoid further drag on profitability.

A Sharp Turnaround

The large law firm market took a steep turn downwards in the second quarter as demand and productivity slumped, while headcount and expenses moved higher.

Optimists may still see the glass as half-full because demand year-to-date is still positive (but just barely at 0.1%), and rate growth is slightly better than last year. But as we move into the second half of the year, most of the key trends are not pointing in an encouraging direction.

Demand was down across most major practice areas. And pessimists see a potentially worrisome sign in that transactional practices, which have largely been the leaders as the market moved higher over the previous nine quarters, had been showing signs of fading strength even before this most recent quarter.

The market still has plenty of time to turn itself around and make it a positive year, but it now faces headwinds that will make it a difficult year to make progress. Expenses need to be brought under control, and headcount needs to be constrained to bring supply into better balance with demand, even as demand for law firm services remains elusive for the moment.

For the past two-plus years, the market enjoyed steady, positive – but unspectacular – growth. Many firms used that period to implement new strategies, adopt new and leaner business models, improve efficiency, and otherwise adjust to a market where they were increasingly faced with growing competition, pricing pressures and slower long-term growth potential.

Both firms that have made adjustments and those that have stuck with more tried-and-true approaches may find their respective strategies put to the test in the months ahead if the market trends remain challenging.

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: Expenses Rebounding

The formula is as basic as Econ 101: profits = revenues –costs.

But as 2016 has progressed, the profit factors are moving in opposite directions: even as demand is weakening, expenses have been growing this year. At a time when revenues are increasingly under pressure, expense growth is threatening to throw profitability even more out of balance.

For the last three-and-a-half years, expenses have been locked into a fairly tight range: direct expenses growing between 1.8% and 3.3%, and overhead expenses in an even tighter range between 2.0% and 2.8%.

Direct expense growth has nearly doubled over the last two quarters, surging to the top of its recent range. This is a result of headcount growth hitting its highest level in four years.

Overhead expenses, meanwhile, have now broken out of their previous range with a significant jump, and are growing at their fastest rate since before the 2008-2009 recession. A closer look shows that while firms are increasing their technology investments, which should yield greater efficiencies, they are pulling back slightly on marketing and business development, which could negatively impact the future pipeline of new business coming in the door. Recruiting expenses, meanwhile, are surging.

After exercising commendable restraint in costs over the past few years, firms are ramping up their spending, and at a time and in spending categories where they can least afford to do so.

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.*