

# PEER MONITOR INDEX

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## PMI Holds Steady in Third Quarter Rates Improve, Demand & Productivity Fall

The third quarter was a mix: rates had the highest growth in two years, while demand declined for the second consecutive quarter. Shake it all together, and the THOMSON REUTERS PEER MONITOR ECONOMIC INDEX (PMI)<sup>1</sup> held steady at 48.

That said, average demand is trending in a negative direction. After the second quarter broke a string of nine consecutive quarterly gains in demand, the third quarter saw not only a continuation of the decline but an acceleration, with the average firm's demand falling 1.1%. Year-to-date average firm demand has fallen into negative territory, down 0.3%.

But helping to offset that was a jump in rates, with firm's averaging 3.1% growth -- the highest rate growth since Q3 2014.

Productivity fell and expenses rose, leaving a market that found itself largely treading water and struggling to maintain current profitability.

### Demand by Practice Areas

Transactional practices, which have largely been a bellwether for the market, turned in a mixed-to-weak performance. Corporate work rose 0.5% and is up 0.5% year-to-date. But real estate fell 1.7% and is down 0.9% year-to-date, while tax work dropped 2.0% and is down 1.9% year-to-date.

Litigation was down 1.9% -- its weakest performance this year -- and is down 1.4% year-to-date. Patent litigation fell 2.6% and is down 2.8% year-to-date.

Patent prosecution has been on the few consistent bright spots this year, rising every quarter. It was up another 1.3% in Q3 and is up 0.9% year-to-date.

Labor and employment was down 1.6% and is down 0.8% year-to-date. Bankruptcy dropped 1.9% and is down 2.6% year-to-date.

### Performance by Market Segment

After leading the pack through the first half of the year, Midsize slipped into second place this quarter, but just barely. Am Law 100 had the best relative performance, with average demand down 0.8%. Midsize fell an average of 0.9%, while Am Law Second Hundred was down 2.0%.

Year-to-date, Midsize is the only market segment showing positive demand, up 0.7%, while Am Law 100 is down 0.4% with Am Law Second Hundred down 1.3%.

A similar trend holds in litigation, where Midsize is the only market segment displaying growth year-to-date.

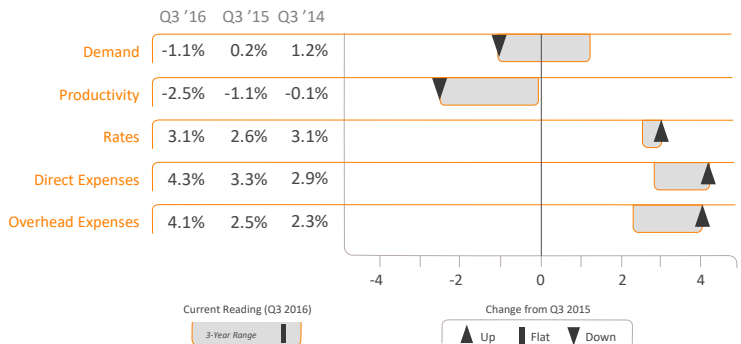
Both Midsize and Am Law 100 are still up year-to-date for transactional practices, especially for corporate work. Am Law Second Hundred is the only market segment that is down year-to-date in all transactional practices.

### PEER MONITOR ECONOMIC INDEX (PMI)

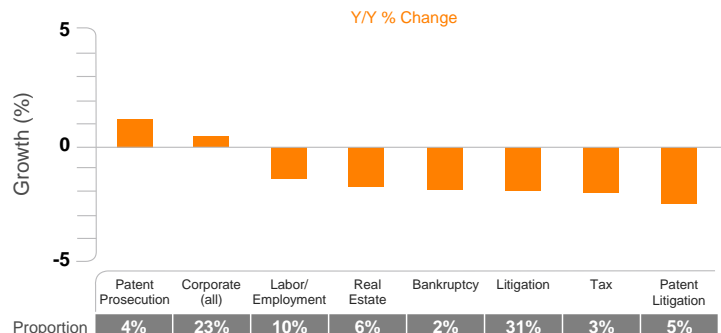


The PMI represents the relative rate of change among the major factors influencing law firm performance. These factors are tracked individually in the graph below.

### 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.

## Rates

Worked rates have improved steadily throughout the year, and rose 3.1% in the third quarter -- the best performance in two years.

Standard rates, meanwhile, were up 3.2%.

Collected realization ticked up to 82.9% -- its best mark of the year.

Cash collections were up only 2.3%, compared with 1.9% in the second quarter.

## Expenses<sup>2</sup>

Expenses have been rising steadily this year, reaching levels not seen for several years.

Direct expenses have accelerated each quarter this year, and were up 4.3% in Q3 -- the highest rate since Q2 2012.

Indirect expenses have also risen every quarter in 2016, up 4.1% in Q3. That is the highest mark in more than eight years, dating all the way back to Q4 2008. While technology, marketing and business development expenses are all rising, the increased overhead is also due to personnel-related expenses, such as recruiting, and staff compensation and benefits.

The jump in direct and overhead expenses is negatively impacting profitability, especially given the slowdown in demand in recent quarters.

## Productivity<sup>3</sup>

Productivity dropped an average of 2.5% -- a less severe drop than the second quarter, but still one of the biggest quarterly declines in the last several years. This was despite the fact that lawyer headcount growth slowed slightly to 1.5%. Productivity has declined 2.1% year-to-date.

The attorney replenishment ratio<sup>4</sup> pulled back slightly to 1.22 -- although that is still near the highest end of the range seen over the last three years.

After ramping up hiring in the first half of the year, firms have eased off the throttle a bit, but may need to let up further if demand continues to slow.

## A Race to the Finish Line

2016 has so far been a year of volatility. The year got off to a strong start, as the first quarter saw the highest demand growth for the quarter in three years.

The market turned abruptly southward in the second quarter, with the demand drop then steepening in the third quarter. Year-to-date, demand is now down by an average of 0.3%. Barring a sharp reversal in the fourth quarter, 2016 could very well be on course to see the first down year in demand since 2013.

On the one hand, that would not by itself necessarily be a drastic change in the market, which has been positive but weak for the past two years. For example, last year the market was barely positive and managed only a 0.3% gain for the entire year.

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

<sup>4</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.

So far this year, the rise in rates has helped offset declining demand, but a continued strengthening of rates may be difficult to achieve.

The end of the year may be headed towards a bumpy but relatively soft landing. The bigger question is where the somewhat mixed trends in demand, rates and expenses all go from there.

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: What Litigation Slowdown, Say the Midsize Firms?

We've mentioned quite a bit over the past several years about the long-term slowdown in litigation work, owing to a number of different factors.

Apparently, Midsize firms didn't get the memo this year. Not only is Midsize the only market to show growth in litigation, but work has risen every quarter in 2016.

This is a continuation of a trend that began last year. In 2015, both Am Law 100 and Midsize were basically flat in litigation work for the year. But litigation has since tailed off for Am Law 100, where the average firm is now down 1.5% year-to-date. Am Law Second Hundred firms are down 3.5% year-to-date.

Meanwhile, Midsize firms are up 1.2% year-to-date, despite some softening in demand in Q3.

Overall demand for litigation work continues to decline, a result of clients seeking to limit their litigation costs, including pursuing fewer "bet-the-farm" cases, and shifting work to lower-cost providers such as legal process outsourcing vendors. Those same cost pressures may also be responsible for the resurgence in litigation work for Midsize firms, as clients move some of their work down-market to smaller firms with more cost-effective pricing.

Litigation work may continue to decline for the market as a whole, but for the moment at least, Midsize firms are enjoying a steady -- and growing -- stream of litigation work.

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

