

## 2015 Client Advisory

“Our challenge is to create a dramatically more client-driven, client-centric organization, where the needs and expectations of clients shape who we are, what we do, and how we do it.”

“We have the opportunity to find and implement innovative ways to help clients meet the challenges posed to them by the pressure to do more with less.”

“Opportunities to grow market share will increase for those who are focused on...differentiation.”<sup>1</sup>

<sup>1</sup>Source: Citi 2014 Law Firm Leaders Survey – responses from three managing partners.

# Executive Summary

As market conditions for law firms stabilize at much lower growth levels, managing partners, like the three quoted on the cover page, are focused on structuring their firms around their clients, innovating wherever possible, and showing clients how their firms are different from their competitors. The results of the last few years, including YTD 2014, provide ample evidence that some are doing much better at adapting than others.

An improved demand environment in 2014 for the law firm industry will likely drive better results than we saw in 2013, as we predicted in our 2014 Client Advisory. However, not all firms have reaped the benefits of an improved demand environment equally. The beneficiaries of the uptick in demand tend to fall into two categories – those with strong brand-name transactional practices, or firms who have demonstrated value to their clients by offering quality work at the right price, while creating a well-managed cost structure to maintain or improve their margins. Firms who have lagged in this market may have done so for a variety of reasons, among them: ill-conceived growth strategies; too much dependence on litigation; and top heavy, expensive leverage models.

Based on our review of financial data, our discussions with law firm leaders, and other economic data available to us, we project that 2015 revenue for the law firm industry will likely rise in the six percent range, and PPEP in the five percent range. We also project expenses to rise in 2015 more so than in 2014, due to lawyer, staff and technology-related expenses. We believe transactional work will continue to drive growth, and litigation demand is likely to remain flat, placing continued pressure on firms with a strong dependence on litigation.

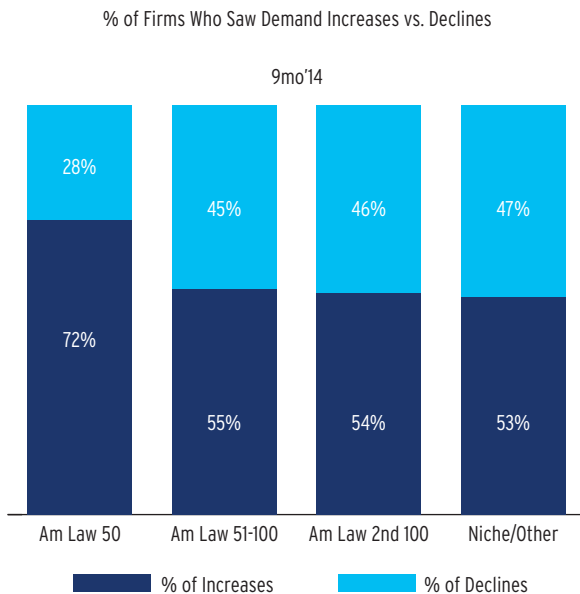
We expect that behind the 2015 industry profit growth noted above, there will be firms significantly outperforming and lagging the industry average, based on their practice mix, brand, focus on client service delivery, and approach to innovation.

# 2014: Great News for Some, Mixed Results for Others

2014 has seen stronger demand growth than in 2013, fueled largely by the uptick in transactional work. However, under the hood of the industry averages, we have seen a striking difference in the performance of various segments of the market, and within each segment. This is a continuation of a trend we saw emerge in the second half of 2013. Comparing the different segments by revenue size, the Am Law 50 has outperformed the rest of the industry, as the beneficiaries of the uptick in transactional work. This resulted in demand growth of 2.4% for the Am Law 50 for the first nine months of 2014, according to Citi Private Bank's Law Watch Quarterly Flash Statistics Report. On the other hand, we continued to see that for firms outside the Am Law 200, demand declined during the same period, while Am Law 51-100 firms saw demand growth of 1.1% and Am Law 2nd 100 firms saw growth of just 0.5%.

There has also been a good deal of dispersion within each segment, as demonstrated in **Chart 1**. These results suggest that within every segment, there are leading and lagging firms.

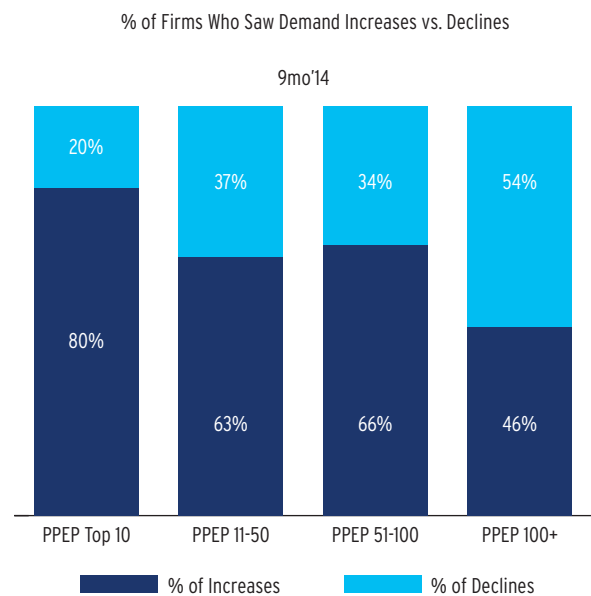
Chart 1: 9mo'14 Demand Dispersion by Am Law Segment



Source: Citi Flash Survey: 9mo'14<sup>2</sup>

The contrast in results is even more striking when we look at industry performance through the lens of profitability. As we saw in 2013, the ten most profitable firms in the Citi Annual Survey<sup>3</sup> continued to outperform the rest of the industry for the first nine months of 2014, seeing demand growth of 6.5% vs. 1.2% for the rest. This resulted in a continued growing separation in the market between the most profitable firms and the rest. Also, as seen in Chart 2, we see there's significant dispersion within each profitability segment. As we saw with the Am Law 50, a key characteristic of these most profitable firms is that they have benefited from the uptick in transactional work. They also remain the "go-to" firms in their selected areas of practice. In an increasingly fragmented market, their results underscore that brand differentiation is key.

Chart 2: 9mo'14 Demand Dispersion by Firm Profitability



Source: Citi Flash Survey: 9mo'14

Demand growth and stronger rate increases have driven stronger revenue growth results than we saw in 2013, despite some lengthening of the collection cycle.

<sup>2</sup>9mo'14 results are based on 178 firms from the Citi Flash Survey: 9mo'14, including 44 Am Law 1-50 firms, 35 Am Law 51-100 firms, 47 Am Law 2nd 100 firms and 52 additional firms.

<sup>3</sup>Results are based on 205 firms from the Citi Annual Survey Database ("Citi Common Firms Database") in 2013, including 45 Am Law 1-50 firms, 34 Am Law 51-100 firms, 54 Am Law 2nd 100 firms and 72 additional firms.

Headcount growth has been modest, and equity partner headcount growth even more so. Headcount growth of 0.6% for the first nine months of 2014 was slower than the 1.6% increase seen in total lawyer billable hours during that period, resulting in some improvement in average lawyer productivity, with the strongest absolute productivity being among associates. On the other hand, partner productivity continues to lag pre-recession levels.

While we have a long way to go to eradicate the persistent excess capacity in the market that has been a key driver of pricing pressure, the overall improved productivity should ease some of that pricing pressure, and help boost revenue growth.

Stronger rate increases in the US have also helped boost revenue growth during 2014. We suspect that with the improved demand environment and the lessening of excess capacity, firms have felt more confident pushing through rate increases, and clients may have been more willing to accept those increases. Clients also tend to be less focused on rates for transactional work (the driver of demand growth in this current market) vs. litigation, particularly when the fees are often paid by a third party.

Published rate increases are a positive sign, however, we continue to see pressure on realization, driven by alternative fee arrangements and pre-negotiated discounts to the published hourly rate. In 2013, realization for the industry was 85.1%, remaining far below the levels we saw during 2002-07, when realization averaged 92.5%.<sup>4</sup> As an indicator of the expected change in the current year's realization, in the Citi 2014 Law Firm Leaders Survey,<sup>5</sup> 46% of large law firms reported that realization had declined during the first five months of 2014. While this is better than the 49% who reported a decline during the same period in 2013, it still represents a significant proportion of large law firms continuing to face pressure on realization. Further, we hear anecdotally that firms have struggled especially to achieve realized rate increases in 2014 outside of the US.

Revenue growth of 4%, together with controlled expense growth (2.4% across the industry for the first nine months of 2014), suggests 2014's margins will increase and profit growth will be stronger than we saw in 2013. Consistent with our comments on demand growth, we expect to see dispersion in the profit results of individual law firms, with leading and lagging firms within every segment of the market. Some firms will likely approach pre-2008 levels of profit growth, even as we project the industry to hover in the 5-6% range. This suggests we'll once again see a high percentage of firms with year over year profit declines.

<sup>4</sup>Results are based on 122 common firms from the Citi Annual Survey Database ("Citi Common Firms Database") during the period 2002-07 and 2013, including 42 Am Law 1-50 firms, 26 Am Law 51-100 firms, 32 Am Law 2nd 100 firms and 22 additional firms.

<sup>5</sup>Citi's 2014 Law Firm Leaders Survey results are based on submissions from 66 large law firms.

# 2015

We expect that 2015 will see similar demand and revenue growth to 2014, largely driven by stronger growth in worldwide transactional activity than we saw in 2014, but with an important caveat. This outlook is somewhat dependent on the stability of the geopolitical landscape in 2015, and the impact any instability might have on global economic growth – and transactional activity. The recent drop in the price of oil could also have some impact on the demand for legal services in the energy sector, though it is too soon to tell if this will be a serious factor. Further, lower demand for litigation could drag down overall growth, particularly in market segments where litigation accounts for more than 50% of a firm's practice.

On the expense side, we expect to see continued focus on controlling increases, though expense growth is likely to be higher in 2015 than we saw in 2014, as areas of expense growth are likely to outweigh saves made elsewhere. In particular, we believe that firms will likely increase their investments in technology. Another area of potential expense

pressure is lawyer compensation. While excess capacity remains an issue, we are hearing from a good number of firms that mid-level associates are in short supply. Whenever demand outstrips supply of talent, upward pressure on compensation usually follows. Our hope is that this will manifest itself in hikes to variable compensation, based on strong performance, and not in base salary increases.

On the other hand, we expect a number of firms will manage down their occupancy expense, the largest expense category after compensation. For firms in the process of relocating or refurbishing their offices, we expect to see more moves to cheaper and more efficiently configured locations, and smaller, more standardized offices.

We expect that the industry profit growth will be in the range of five percent in 2015, and that performance dispersion will at least equal, if not exceed, that of 2014.

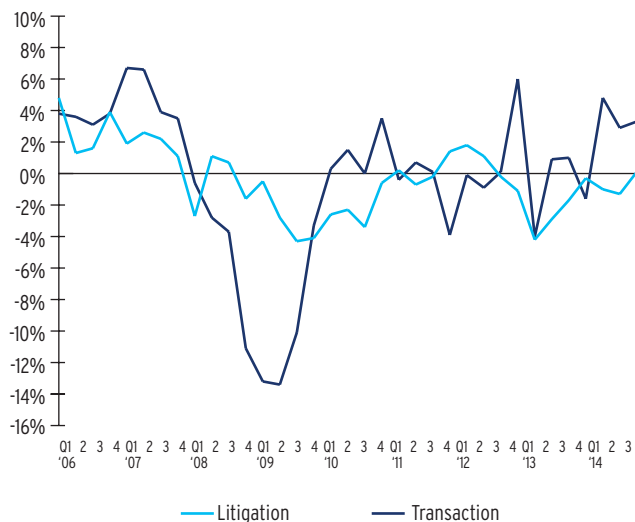
# 2015 and Beyond

The market in 2015 and beyond is likely to be characterized by the following trends:

## Litigation vs. Corporate: A Tale of Two Markets

Just as the uptick in transactional activity is likely to drive demand growth in 2015, we expect to see continued pressure on firms who rely more heavily on litigation. While litigation traditionally drove firm revenue in downward economic cycles, over the past few years, with some exceptions, like intellectual property prosecution or investigations, it has either been flat or declining, as seen in Chart 3.

Chart 3: Demand Growth – Litigation vs. Transactional Practices (All Segments)



Source: Thomson Reuters Peer Monitor data<sup>6</sup>

Changing client behavior is the primary driver of this. Law firms tell us how they have seen a shift in client decisions around when to fight to the end or look for other ways to resolve disputes, whether that be through settlement, mediation or arbitration. Concerned about the impact of unresolved issues on their stock price, companies are more likely to settle earlier than before, and pursue alternative means of resolution to an expensive and high profile courtroom trial. Also, with the explosion of e-discovery,

companies have seen significant growth in the cost of conducting complex litigation, causing clients to think twice about how hard they want to fight.

A second reason for the changed litigation environment is the proliferation of lower-cost legal service providers, who have taken market share from traditional law firms (discussed in more detail in the next section). In reaction to this changed litigation environment, firms have altered their leverage models in three ways. Some have taken the view that they can no longer compete for lower-end work, and have trimmed litigation headcount. Others have sought ways to retain market share by either establishing their own captive lower-cost lawyer businesses, or adding new categories of permanent lower-cost lawyers to their leverage models. Some firms are now also partnering with lower-cost legal service providers.

Even for the firms who continue to see strong productivity in their litigation practices, they tell us that discounting pressure is more severe than experienced in their transactional practices. So, even if they remain busy in litigation, this more pronounced discounting pressure may mean that they will suffer when productivity is converted to revenue. For those firms with heavy litigation practices, and there are many, these current trends, if they continue, could have serious repercussions for future growth.

## The Market for Legal Services and the Market for Law Firm Services are No Longer the Same Thing

Demand for law firm services appears to be growing at a more modest pace than the demand for legal services. Corporate law department spending data suggests that law departments have grown headcount to handle an increased workload, and when it comes to outsourcing, they are increasingly looking to legal service providers beyond traditional law firms.

As for the outside legal service provider market, accounting firms are, once again, building up their legal services capabilities. While we may not be seeing this occur to a large extent in the US, this is a growing trend in markets outside of the US.

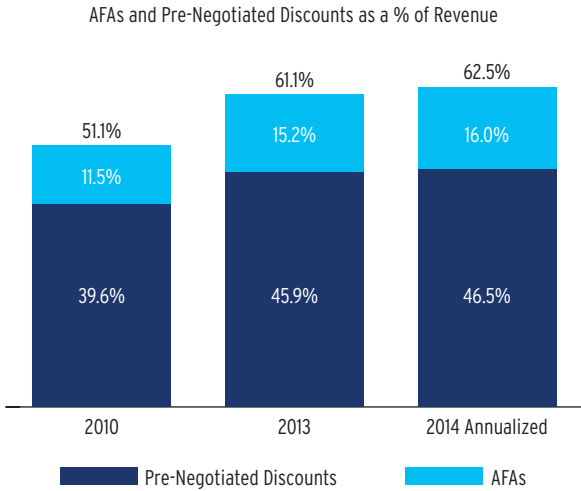
<sup>6</sup>Thomson Reuters Peer Monitor ("Peer Monitor") data are based on reported results from 144 law firms, including 51 Am Law 100 firms, 45 Am Law 2nd 100 firms and 48 mid-size firms (ranked outside the Am Law 2nd 100).

As noted earlier, we also continue to see the growth of non-traditional legal service providers – companies offering contract lawyers at all levels, litigation and corporate document review services beyond just first-level review, and businesses offering to manage legal services on behalf of companies or their inhouse legal teams. According to the Altman Weil 2013 Chief Legal Officer Survey, non-law firm vendor share of the collective budgets of 207 corporate law departments rose from 3.9% in 2012 to 6% in 2013, while law firms' share fell from 52% to 49.6% during the same period.

### Pricing Pressure Remains Strong

With the growing popularity of alternatives to law firms, and a persistent level of excess capacity across the industry, we continue to operate in a buyer's market. We see that pricing pressure affects all segments of the market. According to the Citi 2014 Law Firm Leaders Survey, the proportion of revenue derived through alternative fee arrangements at large firms is estimated to be 16% on average in 2014. Even more significant is the proportion of revenue for these same firms derived through pre-negotiated discounts, estimated to be 46.5% in 2014, as shown in Chart 4.

Chart 4: AFAs and Discounted Rates



Source: Citi 2014 Law Firm Leaders Survey

### We're in a Global Legal Market, No Matter How Local Your Footprint Is

Regardless of where a firm is located, or the extent of its footprint, all firms are operating in a global legal market. Clients want to know that even their locally based firm can serve them in a variety of geographies, whether directly or via some form of network.

To address this, we have seen a lot of consolidation within the US, and we have witnessed the same trend among European and Australian headquartered firms. We have already seen consolidation in Africa and Canada, and we are likely to see more. We are now seeing the regionalizing of local Asian firms, partly in reaction to the success of global law firms in that region.

As Chinese companies continue to hire general counsel, we expect to see more growth of Chinese law firms, both inside and outside of China. One example of the magnitude of change in China is the combination that resulted in King & Wood Mallesons, a firm with over 3000 lawyers in Asia, Australia, and now Europe, as a result of the further combination with SJ Berwin. We do not expect this to be the last such transaction. On the other hand, pricing pressure remains strong, creating pressure on profitability, particularly for foreign firms who have invested in China, and more broadly in Asia, as discussed below.

Consolidation of the legal market in South America is less common than we've seen in Asia. Although there are some exceptions, there is typically not enough trade between South American countries to create the demand for consolidation of national law firms across the continent. One notable exception is the merger of a Chilean firm and a Peruvian firm, who then joined together with a Spanish firm. In an unusual arrangement, the Spanish firm has taken a significant interest in the Latin American merged firm.

We expect to see further expansion of global firms. There continues to be interest by many firms in growing their London practices, given the increased success of a number of US headquartered firms in that market. Conversely, some UK headquartered firms have made it clear that they are interested in increasing their US footprint. So far, they have had limited success, but that could change. It is also clear that global firms have been increasing their footprints in Asia, and we expect to see more expansion in Mexico and throughout South America. Expanding internationally is not without its challenges. Certainly, Citi data shows that pricing pressure, productivity and profitability remain challenges in markets throughout the world. Nevertheless, Citi's data also shows that global and international firms have outperformed the more US-centric firms in the past 18 months.

# Where Will Growth Come From?

## Mergers and Combinations

In an environment where demand growth is hard to come by for the majority of firms, we expect to see further consolidation across the market. We will likely see more pronounced merger activity in various segments of the market. The recent consolidation of two Am Law 50 firms makes us wonder whether this will cause peer firms to consider consolidating. Certainly, Altman Weil has reported that 2014 is on pace to be a record year for law firm mergers.<sup>7</sup> Many have tended to be mergers of strong firms with weaker firms, or mergers of firms who are pursuing growth for growth's sake. On this latter trend, it is our view that these mergers are generally ill-conceived. In our experience, combining separate firm revenues does not necessarily translate into better profit results and long-term success. Rather, the mergers most likely to succeed are those where the partners are clear that the merger will result in better clients, work and laterals. Alignment of partner values is fundamental. In a business where the key assets walk out every evening, and given the active lateral market we operate in, if the values of partners are not aligned, the promise created by the merger can easily evaporate.

## Laterals

Lateral acquisition continued to be a popular growth strategy for law firms in 2014, and we envisage this to continue next year. There are different factors fueling the lateral market. First, firms tell us there are more "tough love" conversations with poor performers, encouraging them to exit the firm, as firms raise the bar on equity partner performance level expectations, and hold partners to those expectations. At firms where these conversations are occurring more than in the past, partners whose performance is lagging may be looking to jump ship before they are pushed out. Second, we sense that there's a "fear factor" at play, at firms who have experienced declining profits over a prolonged period, causing rainmakers to worry that the firm will fail, and prompting them to take their successful practices to firms with healthier profit growth track records. Third, with the level of rate pressure in the market, we've observed movement by partners whose clients refuse to pay the rates the law firm needs. Examples of practice areas where we have seen this happen are real estate and trusts and estates. We've also noted that there are more laterals moving around the top 25 firms, subtly and quietly, than we've seen in the past. In particular, we see the vulnerability of lockstep firms to highly profitable performance-based firms, who are prepared to pay more to younger high performers.

For all the popularity of growth through laterals, the success rate of a firm's lateral strategy can be fairly low. For the past few years, we have asked leaders of large law firms to quantify the rate of success of the laterals they hired over the past five years. Each year, the proportion of laterals who they would describe as being above "break even", by their own definition, has fallen. In 2014, the number was just 54% of laterals who had joined their firms during 2009-13. In addition, when we asked these same law firm leaders to name the top three challenges in expanding internationally or domestically, "laterals" was named as the top challenge for both – by a wide margin. These results indicate that the challenges associated with selecting the right lateral, and successfully integrating them, discussed in our 2014 Client Advisory, persist.

## Organic

A number of firms are turning away from laterals, mergers and combinations, and focusing more on internal growth, most likely achieved by increasing the breadth and volume of work done for existing clients. We continue to see a growing focus on formal client feedback programs and cross-selling initiatives at firms, and the expansion of business development teams, to support the expansion of the range of services offered by a firm to existing clients.

## Which Growth Strategies Will Be Rewarded?

All businesses require growth to be successful. Where the future growth opportunities are likely to come from will be the most difficult issue for firms to solve. Ultimately, for the most successful firms, growth is most likely to come from a firm's ability to develop a strong brand as a market leader in specific practice areas; to continuously respond to client needs; and to implement innovative ways to deliver legal services.

<sup>7</sup>Altman Weil MergerLine for the first nine months of 2014, October 3, 2014



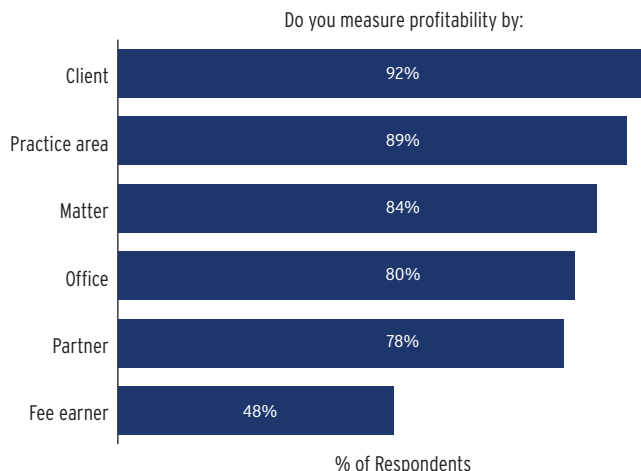
# What It Takes To Be a Successful Firm

There are a number of trends evolving in the market, which we believe will continue to set apart the successful firms from the rest:

## 1. An Increasing Focus on Margin Growth vs. Just Revenue Growth

Given the amount of pricing pressure facing the industry, successful firms have become increasingly focused not just on revenue growth, but on margin growth. Beyond looking at margins at the firm level, firms are looking at profitability by client, matter, practice area and office. As Chart 5 below shows, in the 2014 Law Firm Leaders Survey, 92% of large law firm participants are measuring profitability by client, and a high proportion measure profitability by matter, practice area and office.

Chart 5: Profitability Analysis



Source: Citi 2014 Law Firm Leaders Survey

Measuring margins is not completely straightforward, nor is knowing what to do with the information to effect change. Firms tell us of the challenges in allocating costs across practice areas and offices in a way that is viewed as fair by the partnership. Also, while it's true that analyzing the profitability of any given client, based on work completed, is an important measure, how do firms account for the additional work that may have flowed from other clients or other matters, because of that one client? The concept of "marquee" clients and "loss leaders" may not be obvious from just analyzing the margins on the work done specifically for that one client.

While it's clear that measuring margins has become more important, we still see a gap in how this information is being used to effect real change in the way firms deliver legal services. When we ask firms what they are doing with the margin information, at this stage, it's most likely used to influence partners in the composition of leverage at the matter level. It is less likely to be used to change the composition of leverage across the firm, drive its client and practice mix, influence expense decisions, or determine partner compensation. Indeed, law firm leaders are facing the challenge of shifting the mindset of their partners to view their most important clients not so much as being their top revenue generators, but as the ones who are the most profitable.

Margin growth is top-of-mind for many firms, though our experience is that this is still an emergent area for firms. We will likely see successful firms pay more attention to the use of margin analysis to effect real change in the way they deliver legal services.

## 2. Growing Sophistication on How to Price and Manage the Delivery of Legal Services

Client demands for the more efficient delivery of legal services are translating into pressure on revenue and margins. This is driving firms to focus on building their lawyers' project management skills, in an effort to minimize the time and therefore the cost of doing work, so that margins are maintained, if not optimized. This is still an emergent, but growing trend for firms. In the 2014 Citi Law Firm Leaders Survey, large firms were evenly split on whether they currently provide project management training to their lawyers, consistent with the results we have seen in prior years. The biggest shift was that in the coming year, of the 50% of firms who don't currently offer project management training, 97% plan to do so.

We have also seen a growing presence of full-time project managers at these large firms. Project managers are typically part of the finance team or a practice group, while others are part of IT or Knowledge Management or a project management office. They typically come from a law, consulting or accounting/finance background. 36% of these firms have employed full-time project managers, up from less than 24% in 2012. And of the firms who don't currently have project managers, 49% plan to hire them in the coming year.

Perhaps the most significant development we've observed is the emergence of the full-time pricing specialist. 58% of survey participants have already created this role, while 42% of those who don't yet have a pricing specialist plan to hire one in the coming year.

There is some degree of overlap between project manager and pricing specialist roles. Firms have told us that both would be involved in modeling AFAs, and assisting partners in negotiating either alternative fee arrangements or hourly rate pricing with clients. However, there are two clear points of distinction – while pricing specialists leave it to project managers to manage the timing, cost and scope of matters, project managers leave it to pricing specialists to directly negotiate pricing with clients.

In an industry where we've seen the increasing presence of law department COOs to manage the day-to-day financial and administrative operation of the law department, and the ever-growing sophistication in the analysis of outside counsel spending, it's clear that successful law firms are responding with a more sophisticated team, and in some cases, C level positions, supporting their pricing strategies and the more efficient delivery of legal services.

### 3. A Different Leverage Model

A distinguishing feature of successful firms is the careful way in which they manage their leverage mix. The focus of headcount reductions after 2008 was on associates, while at the same time, we observed growth in the ranks of counsel and income partners across the industry. The net effect was the emergence of a more senior, more expensive leverage model for many firms. This would not be an issue, if it resulted in a more profitable leverage model. However, for many firms, lagging productivity among more senior lawyers, combined with higher fixed salaries, has resulted in a more senior, less profitable leverage model. Of greatest concern for many firms is the income partner category. The same may apply to the counsel category, which is profitable for some, but remains a challenge for others.

One trend we continue to watch, in addition to the active use of temporary lawyers, is the degree to which firms are using permanent non-partner track associates and other lower cost lawyers. We are now seeing these categories appear among some of the most elite firms. When we ask these firms whether they are concerned that expanding their lawyer base beyond partner-track associates will hurt their brand, their response is simply that this is what their clients, and the market in general demands. To ignore this trend would be at their peril.

## 4. Leveraging Technology

Technology has supported the commoditization of many legal services and enabled the provision of those services across the globe, regardless of the physical size and scale of the provider. It has enabled a proliferation of alternatives to law firms to emerge and prosper. Indeed, a key differentiator of lower-cost legal service providers is the way in which they have employed technology to offer more efficient legal services to clients. Legal research, document production, e-discovery document review, billing, and matter and practice management are just some of the areas that have been transformed by technology. While some tasks will always be better managed by third parties, given the rapid nature of technology development, successful firms constantly examine how emerging technology might impact their businesses, and look for ways that it could enable them to deliver quality legal services much more efficiently.

Beyond implementing technology solutions to improve delivery of legal services, successful firms have also recognized the market information advantage clients have held for some time, with the mass of information available in corporate law department matter management systems. Those firms have been focused on ways that they too can leverage technology to better understand their client and revenue mix, and analyze profitability by client, matter, office and practice area. This is enabling firms to more systematically identify opportunities to grow revenue, control expenses, and improve their margins.

Some have said that large law firms are behind the curve when it comes to technology. While those comments made good headlines, the truth is that law firms are investing heavily in technology and in bringing in highly regarded Chief Information Officers from other industries. For many firms, we have observed that technology is fast becoming the highest expense item after lawyers, staff and occupancy.

An area of ongoing interest is the development of artificial intelligence solutions to replace core lawyer skills. We believe that these tools are still a long way off as a scalable technology in law. We've seen that the experience of using artificial intelligence tools in the medical profession has helped medical teams to diagnose complicated illnesses, but it certainly has not replaced doctors. When artificial intelligence begins to have a meaningful impact on the practice of law, we envisage that it will be used as an enabler, not as a threat to law firms.

In creating many opportunities, technology has also created many challenges for the industry. Law firms have been highlighted as particularly vulnerable to information security breaches. The attention law firms give to addressing information security risks is top-of-mind to clients, and the approach firms take will continue to be of concern to clients. Successful firms will likely be industry leaders in maintaining airtight secure systems.

## 5. An Increased Focus on Partner Performance and Skillset

Some industry critics have noted that partnership growth at large law firms has remained at historically low levels, and any growth has been largely driven by lateral hires. However, relatively flat growth in equity partner headcount, as shown in Chart 6 below, masks the turnover of equity partners at firms - including lateral hires, internal promotions and departures. We know both from Citi Annual Survey data on partner mobility trends, and anecdotally, from our conversations with law firm leaders, that successful firms have not kept the composition of their equity partner ranks stagnant. Rather, they have become more focused on creating a high-performance culture, by setting performance level expectations and holding partners accountable for attaining those performance levels. In essence, firms are more likely to exit underperforming partners, to make room for potential high-performers among their senior associates. That is, exit those partners from the firm, rather than strip them of their equity stake and make them income partners.

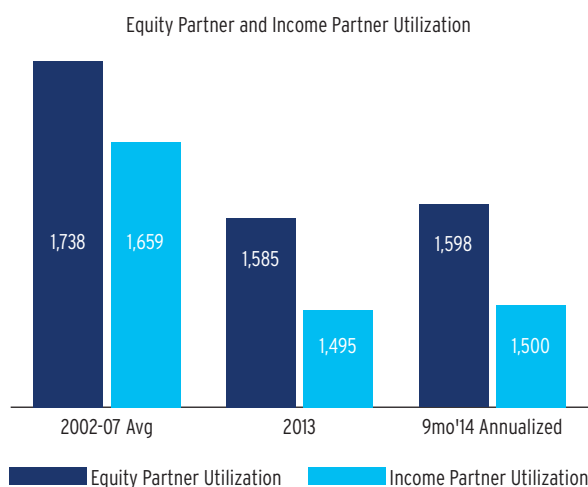
Chart 6: Equity Partner FTE Trend

Segment	2007-'13 CAGR	9mo'14
Am Law 50	-1.1%	0.4%
Am Law 51-100	-0.9%	-0.2%
Am Law 2nd 100	0.3%	1.0%
Other	1.1%	0.9%

Source: Citi Common Firms Database<sup>9</sup> & Citi Flash Survey

However, Citi Annual Survey partner utilization data, shown in Chart 7, suggests that firms could be having more conversations with their partners about performance levels. They could also take a closer look at the contribution made by income partners to overall profitability.

Chart 7: Equity Partner and Income Partner Utilization



Source: Citi Common Firms Database & Citi Flash Survey

<sup>9</sup>Results are based on 162 common firms from the Citi Annual Survey Database ("Citi Common Firms Database") during the period 2007-13, including 45 Am Law 1-50 firms, 29 Am Law 51-100 firms, 45 Am Law 2nd 100 firms and 43 additional firms.

Certainly, some two-tiered partnerships have made the income partner category work very well. This is especially true for firms who use the income partner title as a testing ground for equity partnership, and who have employed an "up or out" philosophy for income partners. For firms who populate the income partner category with underperforming ex-equity partners, the results can be very different.

Beyond partner utilization, successful firms talk of the need for their partners to not just be top subject matter experts, but also to take a more client-centric approach to delivering legal services. These firms are focused on improving the business development and cross-selling skills of their partners, in addition to building their project management skills, as discussed earlier.

Leaders of successful firms also talk about getting their partners to adopt a more long-term, "investment" mindset. In an industry where the profits are typically paid out in a short time to partners, rather than being retained for longer term investment, this can be a challenge. However, with the entry of non-traditional service providers, who have access to long-term funding from those outside the industry, firms need to think about what long-term investments they may have to make in order to remain competitive. Certainly, Citi has seen firms ask more of their partners in investing partner capital, with a paid in capital per equity partner compound annual growth rate of 7.3% for 2002-13.

## 6. A strategic approach to practice and client succession

Succession planning has tended to focus on firm leadership. In Citi's 2014 Law Firm Leaders Survey, large law firm leaders talked of the need to do more succession planning at the practice group level. They also talked of the increased focus on ensuring the longer term sustainability of client relationships. Successful firms are carefully managing the handover of client relationships from senior partners approaching retirement, to younger partners. Often, firms leave it too late to ensure that the transition is smooth. Beyond handing over practices when a partner is retiring, firms need to look more broadly at deepening client relationships across multiple partners. In an active lateral market, whatever a firm can do to institutionalize a client through building multiple deep partner relationships with those clients can only serve to protect the firm against the risks associated with partner departures.

## 7. Differentiating the Brand

A key characteristic of this soft demand environment is the difficulty many clients face in telling one firm apart from another. Brand differentiation has become very challenging, although essential, in a slow growth market.

Law firm leaders have told us that law firm incumbency has never mattered less. Successful firms tend to work hard at being the market leaders in no more than a handful of practice areas.

We are seeing firms define niche specialties and build brands around those niche specialties in the market. For example, we are seeing firms carve out niche litigation practices, such as life sciences litigation, as a means of building a more distinctive brand in the market.

A number of firms have achieved success by building a brand of “innovative legal service provider”. By employing different, lower cost, flexible leverage models; opening lower cost locations; offering more creative alternative pricing models; and employing technology to deliver faster and cheaper high quality legal services, these firms have differentiated themselves in a highly competitive market. Allen & Overy’s peerpoint is a good example of law firms looking creatively at this issue.

In the 2014 Citi Law Firm Leaders Survey, many managing partners also talked of branding themselves as a more client-centric firm, by concentrating more on understanding the client’s specific needs, providing a better client service experience, and partnering with them on alternative pricing models that better meet their needs, discussed in more detail below.

## 8. Client Centricity

We have observed a discernible shift in law firm leaders’ thinking on how best to respond to the evolving needs and purchasing behavior of clients. Earlier in this Advisory, we noted the increased focus on how to respond to pricing pressure in a way that enables firms to maintain, if not improve, margins.

We have also started to see a clear move toward the creation of industry groups and client teams within firms, in an effort to support cross-practice services provided to clients, and to realize the collaboration potential created by having multi-practice, multi-location platforms, discussed further below.

Law firm leaders talk of the need to spend more time listening to clients, and understanding what makes them choose one law firm from another. Going further, successful firms focus on learning as much as they can about a client’s industry, or about how the general counsel and the law department’s performance is measured. They also ask their clients what services they need in addition to managing a specific matter. It could be targeted training sessions, or aggregated news summaries tailored to a specific industry or market. It might be anticipating a client’s needs by sharing an emergent issue other clients have been talking about. The key is to find ways to be in front of clients as much as possible, so that the client

feels valued and is receiving value. The net effect is that the firm is likely to be the “first call” when a specific matter arises. In a market that has become increasingly about price, many successful firms have built relationships by responding directly to what clients have told them they want, or, better yet, by anticipating what clients might need.

## 9. Leveraging the Platform

As firms have expanded both the range of practice areas they offer and their footprint, they are now well-placed to offer clients an all-encompassing array of services. Leaders of successful firms talk of how their clients now require law firms with a global presence. However, the reality for many firms is that partners, located in different offices or practice areas, find it challenging to know the specific skills and expertise of other partners in their firm. Without having a full understanding of the skills and expertise within a firm, collaboration among partners to deliver on the promise of a multi-disciplinary platform, let alone being able to cross-sell services, is very difficult.

At its most basic level, bringing partners from different offices together on a regular basis is key. Creating client-centric or industry-centric groups to share best practices is a common method of building a structure around partner collaboration. Creating formal analyses of work done for a particular client or industry, and then designing and implementing cross-selling strategies, is another means by which successful firms are leveraging their platforms.

## 10. Management of the Talent Pipeline

Earlier, we mentioned the work to be done in holding partners and senior lawyers to higher performance standards, and managing out underperformers. A distinguishing feature of successful firms is that they have carefully managed the performance levels of their equity partners and the various lawyer categories that make up their leverage model. Holding on to underperformers doesn’t just drag down profitability. It also brings down morale among more junior lawyers, who see their future opportunities blocked by the underperformers among the senior lawyers. Concerned with the longer term sustainability of their firms, leaders of successful firms devote a good deal of energy to managing the talent pipeline - from recruitment on.

Successful firms are focused on recruiting the best and the brightest, in a market where they are now competing with not just other law firms, but also investment banks and start-ups. As part of this, they need to articulate what a first-year associate’s career path might look like, regardless of whether they pursue partnership, or eventually move elsewhere.

Those firms carefully invest time and effort in identifying key talent through the associate ranks, and developing those who they’ve identified as high performers. Making clear and

objective assessments of associate potential, throughout their careers at the firm, and managing their development during their time at the firm, enables firms to realize the full potential of their talent pool. An excellent example is the extensive training program implemented by Goodwin Procter for lawyers at all levels. Recognizing that not every associate will make equity partner, firms should be making concerted efforts to have frank conversations with associates about their career path at various stages. Where an associate either does not want to pursue equity partnership, or is unlikely to be a candidate, firms could actively place associates at their clients - good for both the associate and the firm.

## 11. Leadership in a Volatile Market

As we discussed in last year's Client Advisory, the complexity in managing today's typical law firm requires the highest leadership capability we have ever seen in the profession. A slow growth and volatile market, and an active lateral market to match, have made it more challenging than ever before to manage partner expectations - a key requirement in holding a law firm together. Partners may look at a one-year drop in demand or profits, and forget that their firm enjoyed strong performance in the prior year. We have heard how leaders of successful law firms manage partner expectations in this volatile market by talking about performance over a two-year period, in addition to their constant focus on year-over-year growth.

Two key characteristics of a typical law firm partnership present unique challenges to law firm leaders. First, its flat structure makes it more challenging to lead the firm, unlike leading a hierarchical corporate structure. This places leaders in the position of having to influence vs. direct, in order to effect change. Second, the collegiate nature of a law firm partnership makes it particularly difficult to weed out underperformers, yet exiting underperformers is a fundamental part of creating and maintaining a high-performance culture.

To underscore the importance of strong leadership, we would observe that leadership failures of varying sorts led directly to the failure of so many law firms over the last ten years. Irresponsible decision making - a desire to pursue uncontrolled growth, the failure to address poor practice mixes, and a lack of transparency - is the marker of poor leadership.

The unique challenges facing law firms make it critical that leaders manage their firms on a full-time basis, rather than juggling busy practices and the leadership of these complex businesses. While we see the higher caliber of professional staff as a positive trend, we would urge law firm leaders to play their role in a full-time capacity.

## Conclusion

On balance, we believe that the legal profession is stabilizing, and that it will continue to improve. It is clear to us that law firms have the capacity and the talent to adapt to the needs of their clients, and meet the challenges of the future - contrary to those who continually forecast their death. But the challenges call for the highest possible degree of leadership, a continued rigorous approach to managing equity partner performance, and the unleashing of the creativity of the lawyers in the firm.

There are challenges ahead for law firms, but we believe that 2015 will see a continuation of modest growth for the industry, especially if the global economy supports that growth. The key question for any individual firm, in this increasingly stratified market, is "Where will my firm's future growth come from?" It's most likely to come from a firm's efforts to build a brand as the leading law firm in key practice areas, improve their service offering to better meet clients' needs, and implement more innovative ways to deliver quality services.

**This publication is coauthored by Citi Private Bank and Hildebrandt Consulting.**

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