



2017 Client Advisory

"To improve is to change, so to be perfect is to have changed often."

– Winston Churchill

Executive Summary

2017 will likely be another year of modest industry growth in an uncertain and fragile global economy and market for law firm services.¹ Behind the averages, we expect to see continued dispersion and volatility in the performance of individual firms, in line with what we have observed during the post-recession years. Requiring strong and visionary leadership, a high-caliber management team, and each partner's commitment to hard work and profitability, the most successful firms will focus on adapting their business, leverage and partnership models to operate more efficiently and grow revenue under these challenging market conditions.

Building a differentiated brand will be key to growing revenue. Brand differentiation will come from being the market leader in specific practices and, increasingly, specific industries. It will also come through actively seeking out ways to address clients' unique needs. Buying growth through laterals and, in some cases, mergers of equals or acquisitions of smaller firms, will also likely accelerate.

And in a market where clients want the most efficient delivery of legal services, the market will reward law firms who focus on operational efficiency in its broadest sense – not just managing expenses, but transforming the way they run their firms and deliver legal services.

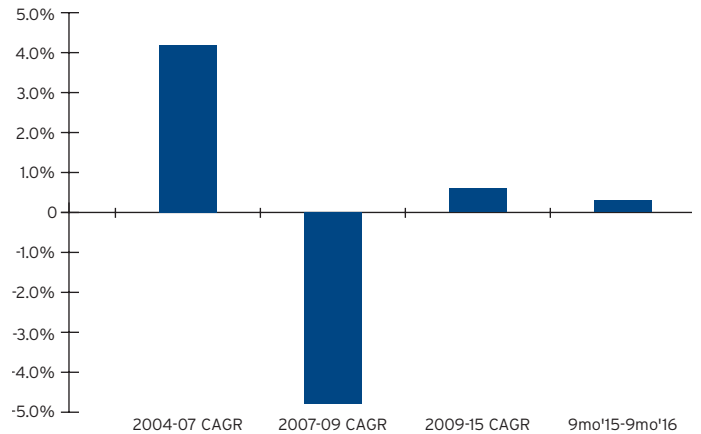
The most successful firms will focus on revenue-related operational efficiency, such as improving how they price work, run matters and manage collections. They will continue to adapt the scale and mix of their leverage models. For many, this will mean adopting a lower-cost leverage model to better match what their clients need. For others, it will be reflected in a better match between salaries and revenue contribution. At the partnership level, the most successful firms will be those who maintain a highly productive, stable and cohesive partnership, rewarding cross-selling and client and practice transition planning efforts.

¹ Our analyses and projections are based on data collected from a sampling of primarily US-headquartered law firms by Citi Private Bank and Peer Monitor, as well as conversations with law firm leaders. For firms headquartered outside the US and third-party providers of legal services, our information is mostly anecdotal. Sources include the "Citi Annual Survey Database" of 205 US-headquartered firms, including 41 Am Law 1-50 firms, 35 Am Law 51-100 firms, 53 Am Law 2nd 100 firms, and 76 additional firms; the "Citi Flash Survey", including 41 Am Law 1-50 firms, 38 Am Law 51-100 firms, 52 Am Law 2nd 100 firms and 57 additional firms; the "2016 Citi Law Firm Leaders Survey" of 51 large firms headquartered in the US, UK, Australia, China and India; and "Thomson Reuters Peer Monitor" data of 165 US-headquartered law firms, including 55 Am Law 100 firms, 45 Am Law 2nd 100 firms, and 65 additional firms ("mid-size").

The Legal Market in 2016

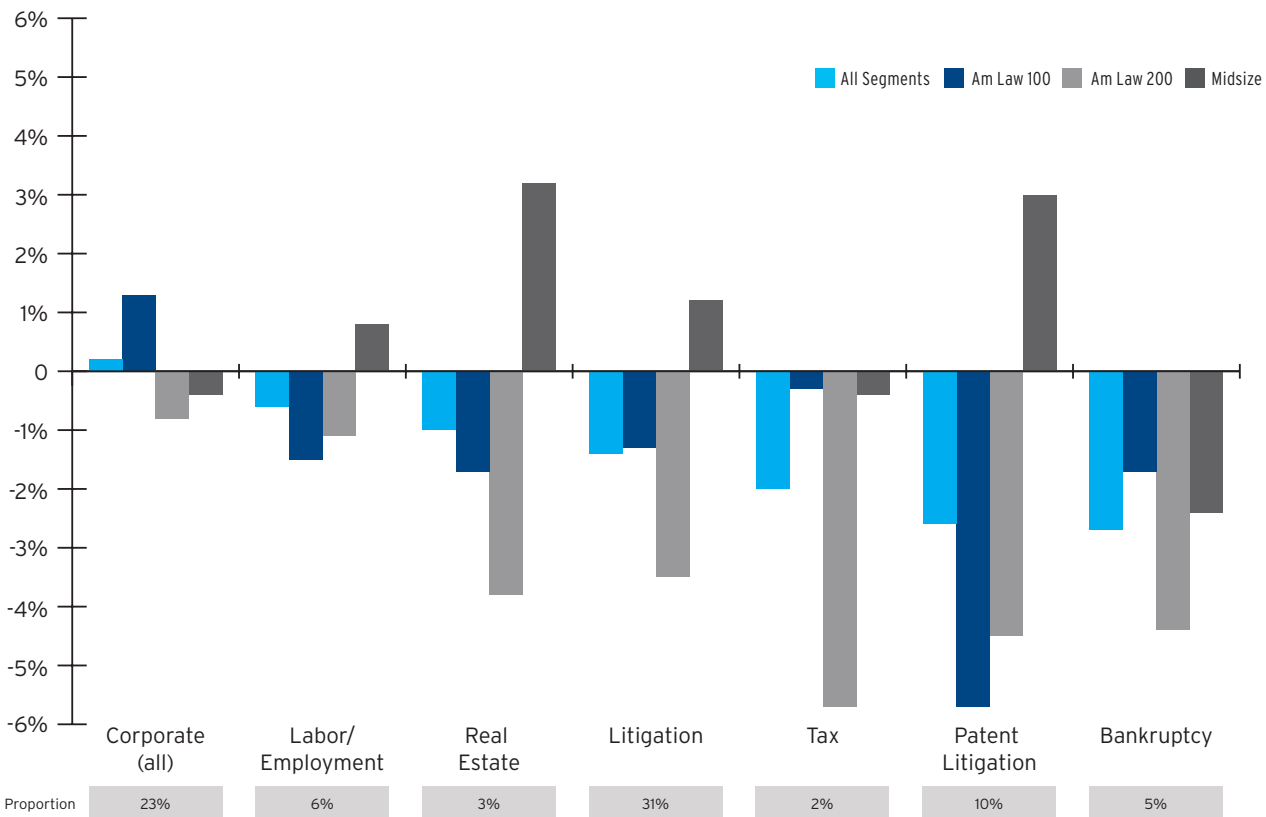
At the time of writing, 2016 was shaping up to resemble the typical annual performance of the law firm industry in these post-recession years. While it is our belief that demand for legal services has grown, demand for services provided by law firms (“law firm demand”) grew a modest 0.3% at the nine-month point, based on Citi data, as noted in Chart 1. There were a number of external events that dampened law firm demand. We saw a slowdown in capital markets and IPOs. Oil prices fell, affecting the energy sector, a key driver of law firm demand in recent years, and shifting work more toward bankruptcy and restructuring, as well as acquisition of distressed assets. There was the surprise of the Brexit vote, dampening transactional activity originating out of the UK and Europe. There was also the surprise of the US presidential election outcome, though at the time of writing, it is too soon to tell how it will affect the remainder of 2016. With regulatory investigations as a main driver of litigation in recent years, firms told us that they saw no slowdown in activity in the lead up to the election. In our conversations with law firms, we heard that demand growth was driven mostly by M&A, particularly in the mid-market cap sector, and by private equity-driven work in general, as noted in Chart 2.

Chart 1: Law Firm Demand Growth, 2004-9mo'16



Source: 120 common firms from the Citi Annual Survey: 2004-15; 168 firms from the Flash Quarterly Survey: 9mo'15-9mo'16

Chart 2: Practice Area Demand, 9mo'16 vs. 9mo'15



All timekeepers. Billable time type; non-contingent matters. Midsize is any Peer Monitor participating firm outside the Am Law 200.
M&A YTD Sept: 3.2% (prop: 3%)

Despite very modest law firm demand growth, revenue was up 3.7% at the nine-month point, driven largely by lawyer rate increases of 3.2%. Rate growth as the primary driver of revenue growth has been the norm now for several years. While rates increased, we saw pricing pressure reflected in realization declining 1.1% at the nine-month point. Also contributing to revenue growth was a 0.6% shortening of the collection cycle.

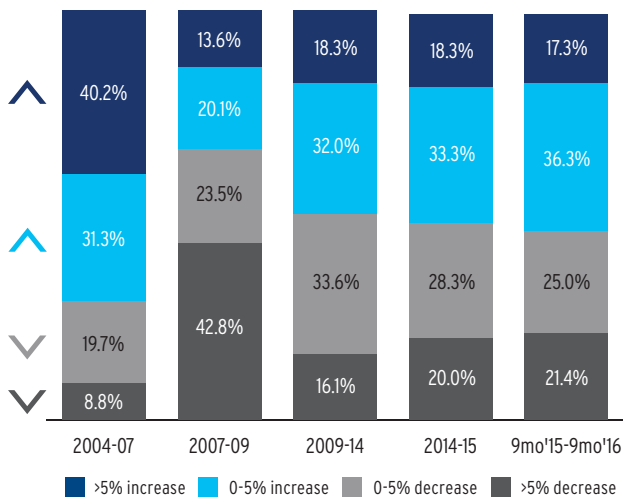
Expense growth was higher than in 2015, up 3.4% at the nine-month point. The biggest contributor to full-year 2016 expense growth will be the increase in associate salaries, after a prolonged period of no change. We saw some of this pressure reflected in the nine-month results, with compensation expense growth up 4.1% vs. the 3% increase seen at the midyear point.

Beyond pressure on compensation expenses, firms have also told us that technology and cybersecurity-related investments were big drivers of expense growth in 2016.

Total lawyer hours grew very modestly, trailing headcount growth and resulting in diminishing average lawyer productivity. This likely placed firms with relatively low productivity under pressure to discount their fees, reflected in the lower realization we mentioned above.

Behind the modest industry performance, we continued to see dispersion between and among the performance of individual law firms, with 46% of firms reporting declining demand through the first nine months of 2016, in sharp contrast to the pre-recession years, as shown in Chart 3 below. Within any given segment, we continued to witness this dispersion, with 45% of Am Law 1-50, 41% of Am Law 51-100, 57% of Am Law Second Hundred, and 41% of firms outside of the Am Law 200, reporting a decline in demand through the first nine months of 2016.

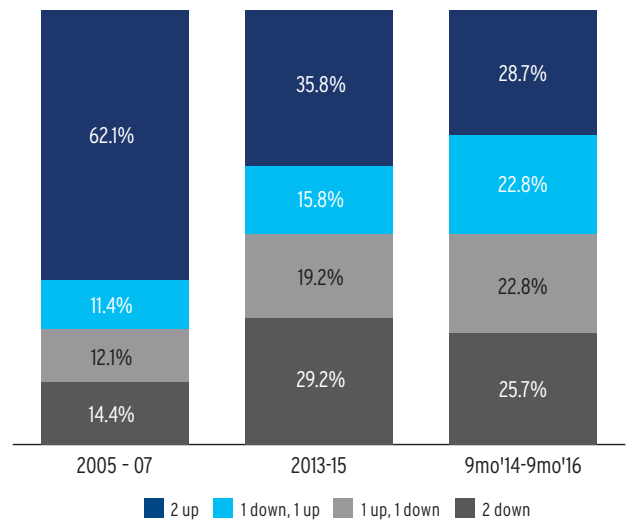
Chart 3: Law Firm Demand Dispersion, 2004-9mo'16



Source: 120 common firms from the Citi Annual Survey: 2004-15; 168 firms from the Citi Flash Survey: 9mo'15-9mo'16

As we wrote in our 2016 Client Advisory, we also continued to see a marked level of volatility in the industry, as measured by alternating years of law firm demand growth and decline, in contrast to the pre-recession years. 46% of firms experienced reverse trends in demand performance from one year to the next over the two years ending in September 2016, as shown in Chart 4. Like dispersion, we observed volatility in every market segment, with 39% of Am Law 1-50, 44% of Am Law 51-100, 50% of Am Law Second Hundred, and 49% of firms outside of the Am Law 200 reporting reverse trends in annual demand performance during this period.

Chart 4: Law Firm Demand Volatility, 2005-07 vs. 2013-15 vs. 9mo'14-9mo'16



Source: 120 common firms from the Citi Annual Survey: 2004-15; 136 firms from the Citi Flash Survey: 9mo'14-9mo'16

With slow growth, and notable dispersion and volatility, we continued to see consolidation in the form of both domestic and cross-border mergers and acquisitions. We also continued to witness an active lateral market, including the lateral movement of groups of partners. Of particular note in 2016 were the lateral moves of star partners between some of the most profitable and traditionally more lateral-shy firms.

We expect that 2016 will be another year of low single-digit profit growth, with some of the events described above continuing to have an impact on performance in 2017, as discussed in the next section.

THE LEGAL MARKET IN 2017 AND BEYOND

2017 Financial Projections

We expect that, similar to 2010-16 performance levels, 2017 will see low single-digit growth in industry revenue and profitability.

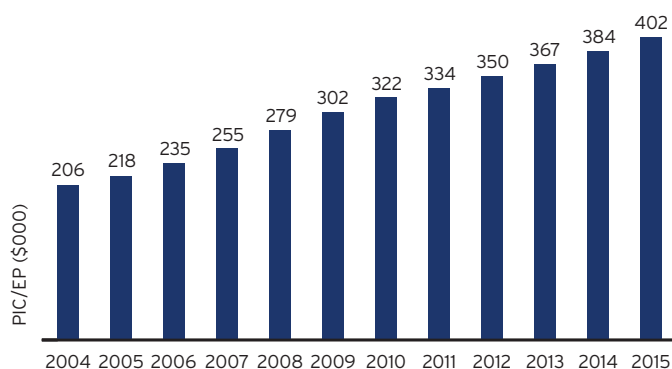
We will see the full impact of the mid-2016 associate salary increases, placing even greater pressure on firms who may not have experienced the levels of productivity and revenue growth to justify raising salaries, but who did so to remain competitive in the talent market.

We also anticipate seeing some pressure on other expenses, as the industry continues to recruit high-caliber professionals, such as Executive Directors, COOs, CFOs and CIOs to lead key business functions. We anticipate more investment in cybersecurity and artificial intelligence, both involving systems and people-related expenses. On the other hand, we expect to see a continued focus on improving efficiency, including shrinking office space, and adopting a less costly leverage model.

Behind the anticipated low single-digit industry revenue and profit growth in 2017, we also expect to see a continuation of the wide dispersion and persistent volatility that has characterized this industry during this post-recession era.

In an effort to maintain strong balance sheets in the face of market pressures, we expect that the majority of firms will continue raising partner capital requirements, as has been the trend for many years, demonstrated in Chart 5. For some, this may also include asking their income partners to contribute capital, a growing trend in recent years. For others, as they consider long-term office space and artificial intelligence investments, we also expect to see more examination of institutional borrowing in this low-rate environment.

Chart 5: Paid In Capital Per Equity Partner (PIC/EP), 2004-15



Source: 120 common firms from the Citi Annual Survey: 2004-15

Key Market Characteristics

Our expectations that 2017 will be another year of modest growth, wide dispersion and continued volatility have been echoed by law firm leaders, in the scores of conversations we have had with them during 2016. In response to the 2016 Citi Law Firm Leaders Survey, law firm leaders highlighted continuing macroeconomic fragility and uncertainty; the erosion of client loyalty; intense pricing pressure; and the increasing presence of artificial intelligence as the biggest challenges they will face through 2017. These are consistent with the challenges leaders of other law firms across the industry tell us their firms face going into 2017.

We would also highlight the shrinking talent pool, and the likelihood of more consolidation and lateral movement. And beyond artificial intelligence, we would note the broad application of technology, both its role in making the management of a law firm business and the delivery of legal services more efficient, and its associated cybersecurity and data privacy risks.

Some of what law firm leaders view as challenges could also be viewed as opportunities. Put another way, these are simply the key market characteristics that firms will face in their search for growth.

Macroeconomic fragility and uncertainty. External factors, such as the ongoing impact of Brexit, the US election result, China's slowdown, and the drop in oil prices, will likely cause law firms to continue to experience a more pronounced level of volatility from one year to the next than they are used to.

Beyond macroeconomic events, law firms will also continue to experience a shift in the competitive landscape. The growth of alternative legal service providers has had some impact, although many firms tell us that it is still relatively small. The Big 4 accounting firms will likely affect firms in their markets outside of the US. Perhaps the biggest shift will continue to come from the size and scope of corporate law departments.

Erosion of client loyalty. Firms can no longer take their longstanding client relationships for granted, causing them to focus more on their business development efforts, and invest more in their business development teams. For institutional law department clients, where RFPs have become the norm, a particular focus of the business development teams will be on achieving a place on panels, and then, once the firm is on the panel, ensuring that it is retained for any given matter.

From law firm client interviews, it is very clear that the major factors in deciding which law firm to retain are the personal

relationships that exist between the client and the law firm, as well as the firm's reputation. Client loyalty is most pronounced where strong personal client relationships exist, and where the law firm has built a reputation for high-quality specialized services.

Intense pricing pressure. Slow industry growth and the erosion of client loyalty will continue to drive the pricing pressure we have seen since 2009. In this buyer's market, where the buyer is often a corporate law department, and therefore a cost center, clients are driven to pay the least amount for the highest value. Pricing pressure is strongest when clients perceive that the work can be done well by a wide array of law firms and other service providers. With a high proportion of firms reporting declining demand and low productivity, the long prevalent tactic of cutting price to win work and keep lawyers busy is likely to continue to be widespread. In an effort to be both competitive and intelligent about pricing, we also expect that firms will continue to invest in their pricing teams.

Technology, artificial intelligence, cybersecurity and data privacy. There were several notable public announcements in 2016 of firms across the spectrum experimenting with artificial intelligence in targeted areas, particularly relating to high-volume transactional work. These firms have adopted the mindset that artificial intelligence presents an opportunity to perform repetitive, high-volume tasks, such as contract review, at a competitive price. We have also heard that law departments are examining artificial intelligence solutions, and have voiced their desire for their law firms to implement these solutions where appropriate.

By partnering with vendors, firms will be able to test the possibilities artificial intelligence presents at relatively low risk to their firms, rather than making a large scale, costly and high-risk investment. Though some firms might view artificial intelligence as a threat, we believe that it will present an opportunity for firms to build stickier relationships with clients. While for now, we see artificial intelligence experiments in small parts of legal practice, we anticipate that, in time, firms will employ it more broadly, enabling law firms to do more with less, and therefore be more competitive in the market.

Beyond artificial intelligence, the broad application of technology will continue to be an important component in a firm's quest to deliver legal services as efficiently as possible. Examples include developing knowledge management systems to improve the turnaround time and quality of work product, or the mining of practice management systems to improve pricing and project scoping.

While there has been a flood of technology start-ups entering the legal industry, it is unlikely that they will all succeed, and law firms will need to be cautious about which solutions to invest in. Firms will also continue to face the cybersecurity and data privacy risks that come with the use of technology.

A shrinking talent pool. Over the last few years, we have seen a decline in enrollments at US law schools. Given the high cost of a legal education and fewer opportunities than before the recession to be hired as an associate, and to ultimately make partner, the best of the best may be pursuing other disciplines in their studies and other career paths. For several years, investment banking competed directly for the best talent, and in recent years, startup companies have become a far more attractive option for millennials.

For the millennials who have decided to pursue a legal career, firms face the challenge of understanding what motivates them, and providing them with a work experience that matches their motivations. This will be key to retaining the most talented among them, and thus ensuring the longer-term success of their firms.

Continued market consolidation. We anticipate that the active lateral market will continue, as some firms gain market share over others, making them more attractive to high-performing partners at weak-performing firms. This dynamic will enable high-performing firms to build on their success, further consolidating their market position. We also expect to see more mergers, as well as acquisitions by larger firms of smaller firms, in a search for revenue growth.

Where Will Growth Come From?

The US market. We expect that transactional matters will drive demand more so than litigation. While 2016 saw a slowdown in capital markets and particularly in the volume of IPOs, we anticipate that, given the high level of uninvested capital held by US-headquartered companies and private equity firms, we might see an upswing in M&A and capital markets work post-election. However, this may not occur until after the Trump administration has been sworn in, when there will be more clarity around its economic policies. At the time of writing, it is too soon to tell what the full impact of a Trump presidency will have on the legal market. However, his pre- and early post-election rhetoric around international trade, infrastructure spending, immigration, taxation and regulation give some indication of a likely boost to law firm work.

On the litigation front, we may see a slowdown in US agency-driven regulatory work under the Trump administration. On general commercial litigation, we have been hearing mixed signals in our conversations with law firms as to whether demand will show some improvement in 2017.

The global markets. The London market has become highly competitive over the course of the last few years between the top UK-headquartered firms and a select group of US-headquartered firms. These firms are also in head-to-head competition for talent, resulting in UK-headquartered firms having to reconsider their compensation systems. There have been a number of changes in leadership in the top UK-headquartered firms and it will be interesting to see how

they will steer their firms in light of a changing competitive market. We would note the substantial first half 2016-2017 revenue growth reported by some UK-headquartered firms as a cautiously positive sign for 2017 revenue growth.

With the surprise of the Brexit vote outcome, many commentators have pondered on what the likely impact on law firms will be. At the time of writing, there is still a lack of clarity on the timing and scope of the UK's formal exit from the EU, making it too soon to tell what the full impact is likely to be on the markets, London as a financial center, and demand for legal services. No doubt there will be strong demand for corporate and regulatory advisory work, though this work requires lower and more senior leverage compared to, say, a typical M&A transaction. We've heard that the UK-headquartered firms are of the view that the market shift toward general advisory work will favor them, although, as the major US-headquartered firms have become more competitive in the UK market, this may not be the case. Also, while the sterling drop and uncertainty around the scope and timing of Brexit might have dampened UK and EU-driven merger activity, it has also created UK buying opportunities for US and other foreign entities. This might very well favor US-headquartered firms with a London office.

If London becomes less of a major financial center, and we see a shift toward some continental European cities, it will likely favor US- and UK-headquartered firms with an established footprint in Europe. Others have expressed the view that any shift away from London is likely to be toward New York, favoring US-headquartered firms with strong transactional practices.

Europe remains a complicated market, particularly with the uncertainty around the form and timing of Brexit. We would anticipate that once there is more clarity, there should be growing demand for legal services in this region. Several firms are reshaping their EU practices in light of the unknowns surrounding Brexit. Some have reduced the size of their German practices, while others are rebuilding them after experiencing poor performance. With many believing that the EU is in a fragile state, firms operating in continental European cities are no doubt carefully watching the growth of populist, anti-EU sentiments in some EU countries.

Growth in Asia has slowed, strongly affected by the China slowdown. However, China's GDP is still growing faster than most, and there are signs that its economy is stabilizing. The Chinese firms had, by and large, a strong 2016. Hong Kong is highly competitive and has been affected by a slowdown in IPOs out of China. Hong Kong as a financial center could be affected by the mainland trying to take control of the markets, and if that happens, Singapore is likely to benefit. We have witnessed a few US-headquartered firms consolidating their Asian offices or withdrawing from the Asian market, and we would not be surprised if more follow.

Australia has experienced a prolonged period of economic growth, though it has been affected by energy prices and lower demand for commodities, particularly driven by the China slowdown. In this highly competitive legal market, the top Australian firms have continued to do well. While not nearly at the levels seen a few years ago, international firms continue to enter the market, given its stable political system and economy, and its proximity to Asia.

Despite the effect on oil and gas prices, Canadian firms had, by and large, a very good 2016, and activity seems to be picking up, perhaps boding well for 2017. The situation in Canada is similar to other countries, where a group of firms at the top are outperforming firms in the second and third tiers. Further, the growing presence and success of foreign firms is slowly reshaping the landscape.

It is clear that globalization has come to the Latin American legal market. We will see more global firms target the market, even though most countries are in or close to a recession. Changes of government in Brazil and Argentina may attract more foreign investment and the further interest of global firms. That said, given the complicated structure of Latin America, success in that region may be hard to come by.

The big story is whether the Indian government will open the market to foreign law firms. The current consensus in India now is that this is inevitable, with discussion around timing and how the market will operate. However, there is still a strong possibility that it may not happen any time soon.

HOW FIRMS WILL SUCCEED IN 2017 AND BEYOND

As long-time observers of the law firm industry, we believe that much of what law firm leaders identified as key market challenges today and in the near future is consistent with what we have seen in the years since the recession. This caused us to examine the approach of the most successful firms in the post-recession years to isolate what they did differently than others. Given our view that 2017 will likely be a year similar to other post-recession years, we believe that studying what these most successful firms have done differently in recent years can provide valuable lessons for success in 2017 and beyond.

We first studied the 2010-15 performance of a group of large firms² who report to Citi. We deliberately chose to focus on large firms to control for the massive swings in performance that tend to occur among smaller firms. Within this large firm sample, we then isolated the most profitable firms who report to Citi, and compared their performance against that of the broader sample of large firms during 2010-15.

Recognizing that the most profitable firms may not be relevant to many firms in the industry, we then excluded those most profitable firms from a second analysis of Citi's full sample of firms during 2010-15. In this second analysis, which spans the industry and includes firms of all sizes, we isolated the strongest performing firms and compared their approach to the rest of the full sample.

We found that there was a strong overlap in the strategies of both the most profitable firms, and the strongest performers among the full sample, together referred to as the "most successful firms" throughout this Client Advisory. These findings are consistent with what we have observed about the strongest performing firms in our scores of peer reviews, and day-to-day conversations with leaders of law firms in this post-recession market, regardless of firm size.

In studying what the most successful firms have done differently, we looked at the law firm model through three different perspectives – the business model, leverage model and partnership model.

The Business Model: Growing Revenue and Profitability

Greater Revenue Growth

The most successful firms have outperformed on top line growth during the post-recession years, primarily through stronger average lawyer productivity and higher rate increases. They have also been very thoughtful about the mix and size of their leverage, as discussed in the next section.

The value of brand. A common characteristic of the most successful firms is that they have built strong distinct brands as leading experts and trusted advisors in a select number of practice areas and, increasingly, industry sectors. Their strong distinct brands, evident across all segments of the market, have enabled them to attract higher rates, and higher rate increases, as clients have been prepared to pay comparatively more for what they perceive as high-value legal advice.

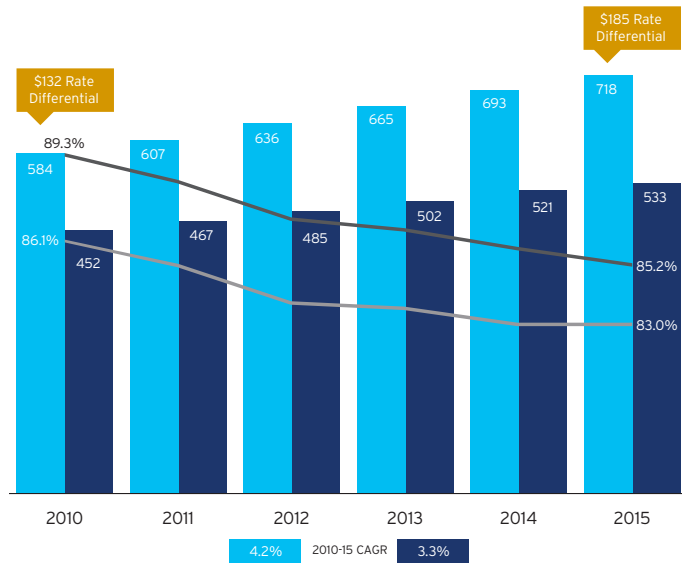
The importance of rate growth. Much has been written about client resistance to rate increases in recent years. However, in a post-recession market where demand growth has been very modest, revenue growth has largely been driven by rate increases. During the post-recession years, our research has shown that the most successful firms raised rates at a greater pace than the broader industry.

Realization declined across the industry as firms were putting through rate increases, signaling strong discounting pressure. However, we observed that this dip in realization did not deter the most successful firms from putting through higher rate increases, as shown in Chart 6. Indeed, some firms may have deliberately put through higher rate increases knowing full well that realization would take a hit. In the end, while those firms may not have realized the full benefit of their rate increases, they were still able to retain some of those increases, as shown in Chart 7, contributing to their comparatively stronger revenue growth.

In our meetings with law firm leaders, we often hear of partner resistance to pushing through rate increases, usually citing current client feedback. In an environment of heavy pricing pressure, reflected in declining realization, we recognize that it has been a challenge for law firm leaders to influence their partners to adopt higher rate increases. However, these results suggest that perhaps clients have tolerated a rate increase, so long as there was a stronger discount given. It could also suggest that while firms may have met resistance from some existing clients, they were able to introduce higher rates to new clients.

² Predominately Am Law 1-50 firms.

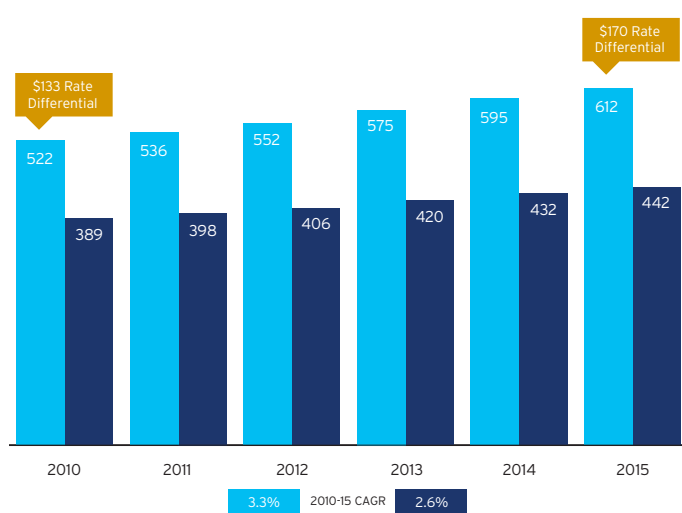
Chart 6: Average Lawyer Billing Rates and Realization, 2010-15



Source: 159 common firms from the Citi Annual Survey: 2010-15

■ Most Successful Firms (MSF) Lawyer Rates ■ Most Successful Firms (MSF) Realization
 ■ Industry, ex-MSF Realized Lawyer Rates ■ Industry, ex-MSF Realization

Chart 7: Average Realized Lawyer Billing Rates, 2010-15



Source: 159 common firms from the Citi Annual Survey: 2010-15

The multiplier effect of productivity and leverage. The most successful firms have simply maintained higher productivity levels and have taken a more thoughtful approach to the size and mix of their leverage. While some have grown their leverage, others have kept it relatively steady, ensuring that their lawyer population is high-performing. They have also altered the mix of their leverage, in response to client demands for the most efficient delivery of legal services, and to ensure that they have a profitable leverage mix. These different approaches are discussed in more detail in the next section.

A better experience with alternative fee arrangements (AFAs). The growth of AFAs has been much slower than many predicted, remaining at roughly 16% of revenue in 2015 and in projections for 2016, according to the 2016 Citi Law Firm Leaders Survey. Some industry commentators have suggested that the problem has been law firm unwillingness to change. However, the reality is that most of the resistance has come from clients who are not comfortable with what law firms have proposed as AFAs, and would rather stay with hourly rates and discounting.

While the proportion of AFAs across the industry has remained low, the most successful firms have seen an even lower proportion of revenue coming from AFAs than other firms in the industry. They have also had a better experience with them, citing a number of reasons. Firms have told us that AFAs have forced their firms to be more rigorous in the way they price services, staff matters and generally manage the matters to budget. For some, AFAs have enabled them to stay close to their clients, leading to their retention for premium, high-value work.

Greater Focus on Margin Improvement

The presence of AFAs, and discounting pressure in general, drove firms of all stripes to increase their focus on margins over the past few years. For many, their focus was on managing expense growth. However, the most successful firms were more focused on improving client and matter profitability through revenue-related efficiencies. They concentrated more on improving matter management than on controlling overhead expense growth. This included focusing more on how to better price services, apply the right leverage mix to a matter, and generally manage matters to budget, to avoid scope creep, reduce write offs and improve profitability of clients and matters.

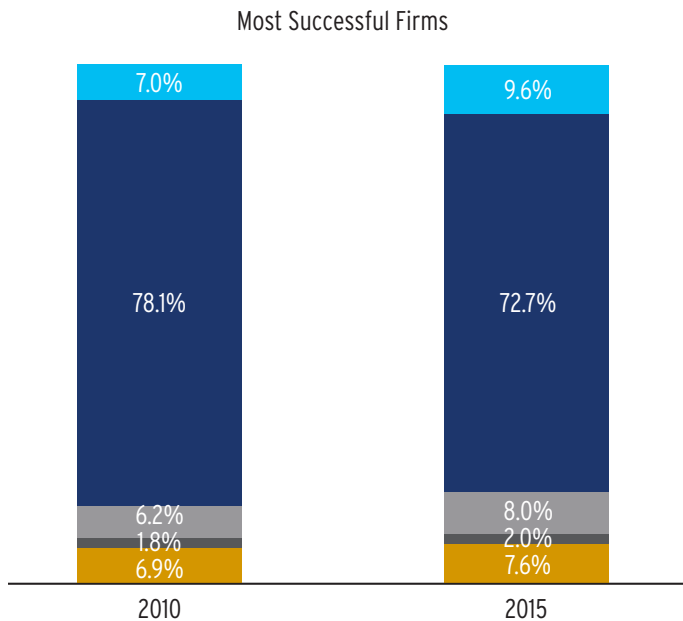
Expense management, particularly in the form of controlling real estate and compensation expense growth, has also been critical in this slow-growth market. We have seen the most successful firms reduce their staff to lawyer ratios. We have also witnessed firms at the end of their lease cycles reexamine their real estate size and configuration, with the goal of lowering their square footage. In the past, firms may have relied on their landlords to pay for office fit-outs, rather than coming to their banks to provide long-term debt facilities. However, we have observed that as firms are paying more attention to expense ratios, they are increasingly realizing that landlords will recoup the cost of refurbishments and fit-outs in higher rent. In a market of low interest rates, the cost of higher rent can be significantly more than borrowing, driving more firms to explore taking on long-term debt as a pragmatic expense management strategy.

In 2017 and beyond, top-line growth through maintaining a differentiated brand, higher productivity, the right leverage size and mix and continued rate increases, together with a focus on both revenue-related efficiencies and expense management efforts to improve margins, will likely be distinguishing features of the most successful firms.

The Leverage Model: Adapting to Shifting Market Demands

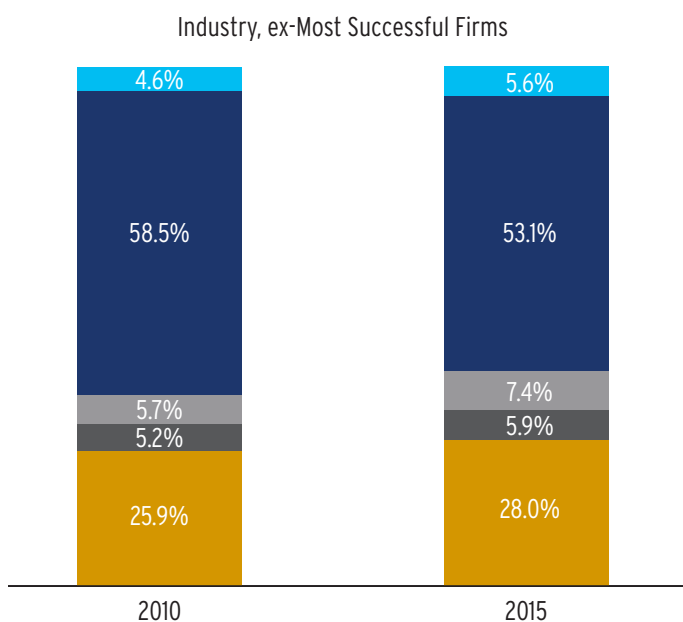
In a slow-growth environment, where pricing pressure is rife, and law firms face competition from lower-cost competitors, the most successful firms have taken a range of approaches to the scale and mix of their lawyer leverage during the past five years, making adjustments in response to market demands.

Chart 8: Composition of Leverage, 2015 vs. 2010



Source: 159 common firms from the Citi Annual Survey: 2010-15

Temp/Other Lawyers Associates Counsel
Of Counsel Income Partners



Source: 159 common firms from the Citi Annual Survey: 2010-15

While we have witnessed shifts in the composition of leverage across the industry as noted in Chart 8, it is evident that the most successful firms have remained more dependent on lower-cost lawyers in general. They rely more on associates, who are comparatively more junior than those at other firms. They also use a greater proportion of lower-cost temporary/contract lawyers and permanent, non-partner track lawyers than other firms.

At the more senior end of the leverage model, while the most successful firms have increased their numbers of income partners and counsel over the past five years, they still maintain a lower dependence on these categories than other firms, resulting in a more junior, lower-cost leverage model than other firms.

The net effect of the adjustments they have made to their leverage models is that the most successful firms see a comparatively better match between revenue generated by and compensation paid to their lawyers.

Making the income partner category work. The most successful firms have depended considerably less on income partners than the industry norm. Of the income partners they have, they have seen comparatively greater productivity than we have seen in general across the industry. We typically see high-performing income partners at firms who manage this category carefully, mainly using it as a stepping stone to equity partnership. The firms whose income partner model is based on an “up or out” policy have consistently seen the highest income partner performance levels in the industry. While income partner productivity is higher at the most successful firms, they have also widened their rate advantage, resulting in a considerable revenue per income partner advantage over other firms. While they pay higher salaries, their comparatively stronger revenue per income partner more than makes up for the salary differential, resulting in a considerably stronger contribution to overall firm profitability. In a market where we all too often see firms with income partners making a negative contribution to firm profitability, it is striking how different the experience is for firms who have managed this category well.

We have seen notable differences across the industry in how firms are approaching the use of the income partner category. Over the past five years, a number of firms have eliminated the income partner category by “re-equitizing” their income partners. On the other hand, we have heard recently of several large firms considering the adoption of an income partner model, as part of the process of “de-equitizing” partners. Our experience is that taking this latter approach has worked poorly in many firms, as stripping partners of their equity stake does little to improve their performance.

Counsel: a more profitable alternative to the income partner? Over the past few years, and in response to the limited opportunities to make equity partner, we have noted the growth of the counsel category across the industry, at

both single-tier and two-tier partnership firms. Consistent with the income partner category, the most successful firms have comparatively more productive counsel, who attract higher rates than the broader industry. While, like their income partners counsel salaries at the most successful firms are also comparatively higher than other firms, their revenue contribution more than makes up for this differential, resulting in a markedly stronger contribution to firm profitability than we see across the broader industry.

As for comparing the performance and contribution of counsel vs. income partners, we have observed that average realized rates for each are very similar at the most successful firms, in many instances, income partners at the most successful firms are more productive, suggesting a greater contribution to profitability. However, counsel are paid less than income partners at the most successful firms, despite attracting similar rates. This salary differential has been the primary driver of the considerably stronger contribution to overall firm profitability by counsel over income partners.

We have seen the most successful firms employing the counsel role as an effective alternative to income partners. By offering a career path to talented associates who may not make partner, and building leverage under them, the most successful firms have found a way to retain senior talented lawyers in a way that makes economic sense.

The one caution of course is that, like the income partner category, firms will need to carefully manage the growing counsel category, ensuring that salaries continue to appropriately match revenue generated, and that contribution to firm profitability remains positive.

Associates: A shift in size and demographics. Law firms across the industry have reduced their dependence on associates in recent years, by both increasing the proportion of income partners and counsel, and the proportion of other lower-cost timekeepers. The shift to the latter has been largely market-driven, as firms have sought ways to deliver legal services more efficiently in a price-sensitive and unpredictable market.

While firms have shifted away from associates, they contribute proportionally more to a firm's net income than their share of leverage would suggest. Perhaps this is why we have continued to see the most successful firms employ a comparatively greater proportion of associates than the broader industry. They have also maintained a more junior mix of associates.

Lower-cost alternatives to associates. We have seen increased use of cheaper alternatives to associates – temporary/contract lawyers and permanent non-partner track lawyers in recent years. While their rates are lower than associates, they are highly productive at the most successful firms, and tend to be paid lower salaries than we see at other

firms. As a result, they have been a comparatively more profitable addition for the most successful firms than for other firms.

That said, the overall contribution to profitability of these lower-cost lawyers is less than associates, even for the most successful firms, which begs the question, "Why use them?" As firm leadership frequently tell us, the market expects that firms will use the most efficient resource mix on any given matter. Firms recognize that the work will go somewhere at that price, and in order to protect the broader relationship with a client, they are prepared to adapt their models. Indeed, taking this pragmatic approach appears to have rewarded the most successful firms.

Looking forward, firms generally anticipate growing their leverage among the more junior categories. The majority of respondents to the Citi 2016 Law Firm Leaders Survey actually plan to increase associate headcount, reversing the trend we have seen in earlier post-recession years. As for movement in the use of temporary/contract lawyers and permanent non-partner track lawyers, it appears that the most successful firms feel they have the right mix of these lower-cost categories. We noted with interest that other large law firms, who have relied less on these lower-cost lawyers, plan to increase their use of them, likely in response to market pressures.

We believe that in 2017 and beyond, the most successful firms will continue to closely examine their leverage models in light of the market pressures they face. They will adjust their models to better match salaries and other costs to revenue generated. For many, there will be a shift away from income partners to counsel. For some, there will be a more general shift away from senior, expensive timekeepers to a more junior, flexible and cheaper leverage mix.

There are two further observations we would make about leverage. First, we would anticipate that firms will continue to examine ways in which technology can be used to reduce the cost of people leverage, by pushing work traditionally done by associates to lower-cost lawyers or paralegals. Second, we would also envisage firms broadening their leverage beyond lawyers, paralegals and other traditional timekeepers, to meet the demands of this shifting market. This could mean more fee-earning project managers, programmers or cybersecurity and risk management advisers. For health care practices, it could mean using medically qualified people. More firms might adopt business models that extend beyond the traditional delivery of legal services, such as flexible lawyer staffing businesses or law department managed services. Our one note of caution is that in taking a creative approach to leverage, we have seen firms adopt models that did not fit the core business of their firms, and have often proved to be unprofitable ventures.

The Partnership Model: High-performance, Cohesion and Sustainability

Having a high-performance, stable and cohesive partnership have been the key attributes of the partnership model at the most successful firms, enabling them to attract and retain top talent, and thus further separate themselves in this dispersed market.

A high-performance culture. Key characteristics of the most successful firms are their strong equity partner productivity and revenue generation. Each partner is committed to hard work and profit growth. When everyone is pulling their weight, the partnership has a better chance of remaining cohesive and stable. The more aggressive encouragement of early retirement we see by many law firms in the industry suggests that firms are focusing on improving performance levels across the partnership.

A reassessment of the compensation model. The most successful firms have paid close attention to how they reward their equity partners, especially their top performers. The typical compensation model directly addresses reward for performance, informed by both financial and non-financial metrics. Indeed, we have seen shifts occur in the compensation systems of lockstep and modified lockstep firms, to remain competitive in the market for talent. Examples include the introduction of more gates on the ladder to review performance and adjust compensation appropriately, and more focus on bonus pools to reward high-performance and top talent.

A more considered approach to lateral hiring. The most successful firms in the post-recession years have had a much stronger rate of success in their approach to lateral hiring than the broader industry. We have observed that the most successful firms tend to take a considered approach to hiring laterals, making sure that there is a strong cultural, client and economic fit.

The experience has been quite different for many firms in the industry. They have had a disappointing success rate with their laterals, yet have been just as likely to grow their partnerships through lateral hiring, as they have through internal promotions. This means fewer long-term career opportunities for key associate talent, making it a challenge to hold on to the pipeline of talent they have invested so heavily in.

Lower partnership turnover. While the industry has seen absolute equity partner headcount remain essentially flat over the past five years, we have seen turnover behind the net number, as new partners have been added, replacing partners who have retired or moved elsewhere. The most

successful firms have seen less turnover than the rest of the industry. On the one hand, this might limit the opportunities for associates to be promoted. On the other hand, these firms grow a higher proportion of their new partners through internal promotions than the broader market, potentially resulting in more opportunities than at a firm that favors growth through laterals. The net effect of lower turnover is that the most successful firms maintain more stable, cohesive partnerships.

The challenge for firms who experience stronger turnover is how to maintain a strong cohesive partnership and firm culture, especially in the face of increased reclassifications and departures to other firms.

A focus on client and practice succession planning. Building institutional relationships with clients that extend beyond an individual or a small group of partners has been key for the most successful firms. To some degree, it has protected them from the loss suffered through regretted partner departures. It has also ensured that there is longevity to their client relationships, extending beyond the current generation of partners working with those clients.

Effective governance. Law firms are complicated businesses in an increasingly competitive global market. The most effective leaders have a vision for their firms and possess strong partner management and communication skills. Such leaders, and there are many, also recognize the enormous benefit of hiring competent executive talent to manage their firms.

It is also true that many large firms have both a chair and a managing partner, as size has simply made the role of leading a firm too big for one person. Among the most successful firm chairs, we have observed that, as the public face of the firm, they spend a large portion of their time outside their firms, interacting with the firm's clients, and seeking out ways to continually differentiate their firms in this highly competitive market.

Diversity

The law firm industry continues to lag other industries in its level of diversity, particularly gender diversity at the partnership level. While the 2016 Citi Law Firm Leaders Survey found that women made up roughly 45% of associate headcount in 2015, the proportion of women partners was just 17%, a slight upward shift from 15% in 2010. On the other hand, a more significant shift has occurred in the representation of women at the firm governance level, growing from 12% in 2010 to almost 22% in 2015. Law firm clients have increasingly focused on including more women and other minorities in their law firm hiring decisions, and have told us that they are likely to see a better outcome when they are represented by a more diverse team of lawyers.

Conclusion

As we look toward 2017 and beyond, in a market that is likely to experience continued slow growth, wide dispersion and volatility, leading to continued consolidation, we anticipate that the market will favor firms who are bold enough to make the necessary changes to their business, leverage and partnership models. As they look for revenue growth opportunities, the market will reward firms who continue to focus on differentiating their brands, working hard, and pursuing clients and matters that generate profitable revenue growth. It will reward firms who focus on both revenue-side and expense-side operational efficiency. It will favor firms who adapt the size and mix of their leverage models to match market demands for the most efficient legal services. At the heart of their success will be strong, visionary leadership, supported by a high-performance partnership, who are committed to recruiting and retaining the best legal talent and building long-term, deep client relationships which extend beyond the current generation.

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