2013 Client Advisory

"The greatest danger in times of turbulence is not the turbulence; it is to act with yesterday's logic." — Peter Drucker, management consultant, author and "social ecologist"

For the legal industry, the results in 2012, another turbulent year, were largely a repeat of trends that emerged over the prior three years. In fact, we think it is time to let go of any lingering notion that the industry will revert to the boom years before the Great Recession anytime soon. With profit growth and other financial indices reaching lower setpoints in the past four years, we anticipate that the current state of the industry will remain the norm for the foreseeable future. With this view in mind, we are taking a step away from our typical year-on-year analysis. Part I of this Client Advisory contrasts the four years prior to the Great Recession and the four years after, to discern the hard lessons learned by law firm leaders. Part II discusses how to apply those lessons going forward, using today's logic.

Private Bank

HILDEBRANDT CONSULTING LLC

citi

Part I
Where We've Been and Where We're Going

INTRODUCTION

The dramatic difference in financial performance between the periods before and after the Great Recession is demonstrated in Chart 1 below, drawn from comparative data assembled by Citi Private Bank.[1] The chart compares the compound annual growth rate (CAGR) of the legal market in the 2004-2008 period against the 2008–2012 period. It reveals dips in performance across all key indices.

Chart 1: Legal Industry Performance by Period

Metric	2004–08 CAGR	2008–12 CAGR
Demand	3.7%	-0.4%
Rates	6.7%	3.4%
Revenue	9.8%	0.8%
PPEP	6.0%	1.7%

All signs suggest that the more recent four-year trends will continue into the foreseeable future. This is buttressed by a longer look back at the historical data. That data suggests that, in fact, the boom years (roughly, 2001–2007) were the aberration, and what we are experiencing now is more characteristic of the legal market before the boom years. The 1.7 percent PPEP CAGR of the 2008–2012 period is far below the double-digit profit growth that typified the boom years – and is even lower than the PPEP CAGR of 3.9 percent during 1992–2001.[2]

But the "new normal" is different from the "old normal" in a number of important ways. For instance, the market is far more global today. Technology has changed the way law firms work, helped clients to better analyze their legal spend and enabled the entry of nontraditional legal service providers to the market. The traditional law firm leverage model is also changing, with income partners and counsel comprising a higher percentage of the total attorney pool and other variations – career lawyers, contract attorneys – entering the mix. We are currently witnessing a high point in lateral movement. Pricing pressure is more intense, exacerbated by clients who are not just demanding and getting discounts, but also scrutinizing and questioning invoices to an unprecedented degree.

THE TOUGH LESSONS OF THE PAST FOUR YEARS

We have identified four hard lessons learned over the last four years that we hope law firm leaders will take to heart as they guide their firms over the coming years. With the exception of a few outliers who are doing exceptionally well, these lessons apply across the legal industry.

1. FIRMS MUST EARN DEMAND GROWTH

In 2004–2008, the demand CAGR was a robust 3.7 percent. In contrast, in the 2008–2012 period, the demand CAGR actually declined by 0.4 percent, although the last two years saw flat to modest growth. Continued uncertainties in the global economy have put a damper on transactional activity. Clients are showing less inclination to fight to the last breath in litigation. They are also keeping more work in-house, and farming out work to non-traditional legal service providers.

Firms are doing various things to earn demand growth. They are offering fee discounts and other value-adds to secure work. Some are also focusing on work that is less prone to being brought in-house or to competition from other firms. However, many firms still have a way to go in revising their strategies and tactics to address this new reality.

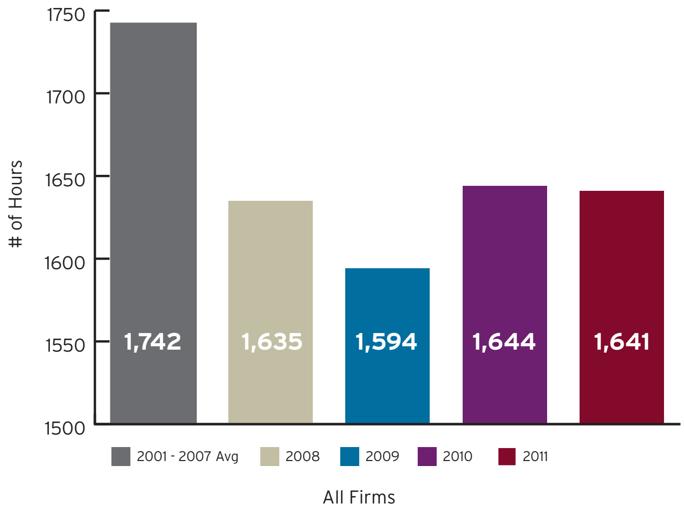
[1]The CAGRs for the periods 2004-2008 and 2008-2012 are derived from two sources: (1) Citi Annual Survey of 148 common firms (78 Am Law 100 firms, 34 Am Law 2nd 100 firms, and 36 additional firms), 2004-2011; and (2) a sample of 79 common firms (50 Am Law 100 firms, 20 Am Law 2nd 100 firms, and 9 additional firms) from the Citi Flash Surveys: 9mo'04, 9mo'08 and 9mo'12. All data for this Client Advisory are derived from these two sources unless otherwise specified.

[2]Source: Citi Annual Survey of 107 common firms, 1992-2001.

2. EXCESS CAPACITY SQUEEZES MARGINS

Although firms have taken a few steps to address the prolonged drop-off in demand growth – a drop-off that we believe will continue into the foreseeable future – excess capacity continues to be a major concern. As demonstrated in Chart 2 below, average productivity since the Great Recession has been roughly 100 hours per lawyer less than in the pre-recession years.[3]

Chart 2: Attorney Productivity



Although an uptick in demand may help to shrink this gap, most firms are nowhere near to closing this gap completely. This supply/demand imbalance creates pricing pressure, since buyers – firm clients – have greater leverage to press for discounts, and firms are more inclined to give them.

The good news is that associate productivity is approaching pre-recession levels. But this improvement is more than offset by the lower productivity levels seen among both income and equity partners. Annual billable hours per lawyer for both partner classes in the post-recession period have fallen far short of the pre-recession period.

To exacerbate the problem, associate ranks have shrunk in recent years, while the percentage of income partners has climbed. Associates made up just 64 percent of salaried lawyers in 2011, down from 81 percent in 2001. Conversely, income partners accounted for 19 percent of salaried lawyers in 2011, up from 10 percent in 2001.[4] The result is a more expensive leverage model, which can work if expenses are offset by a greater increase in revenue. In fact, a few firms have managed to do that, by composing their income partner group with senior associates and lateral hires on track to become equity partners, who tend to be highly motivated to perform. An up-or-out policy at these firms also keeps the income partner group from turning into a repository for less-productive lawyers.

These firms, unfortunately, are the exception. Industry-wide, not only has the productivity of income partners dropped significantly from the pre-recession period, but this group is also consistently much less productive than either equity partners or associates, averaging about 150 fewer hours per year over the past decade. Unsurprisingly, the increasing percentage of income partners has had a negative impact on profitability in recent years.

It seems unlikely that this productivity gap will close in the near future. Although the rate of de-equitization of partners to income partner status has slowed, this tactic continues to be used. Firms have also shown a continuing reluctance to weed out unproductive income partners or other pockets of excess capacity.

[3]2012 preliminary results indicate that the 100-hour gap will widen somewhat.

[4]Source: 117 common firms from the Citi Annual Survey, 2001-2011.

With too many lawyers chasing too little work, pressure from clients to provide discounts and other forms of pricing concessions has become a fact of life in the current market. Clients today clearly have the upper hand when dealing with law firms on price, and they are using their newfound bargaining power with alacrity. In turn, many firms have been agreeing to these discounts in a bid to win work, with the thinking that it is better to keep lawyers' plates full with lower-billing work rather than half-full with full-priced work.

Not even the 20 most profitable firms (Top 20 Firms[5]) are exempt — in fact, the financial services companies that many of these firms traditionally serve have been among the most insistent in banging the table for discounts. At the other end of the spectrum, firms with commodity-type practices are finding themselves competing with alternative providers of legal services like Axiom Legal, Paragon Legal and VLP Law Group.

As a result, average realization rates have hovered in the 88 percent range in the last several years, significantly lower than historical realization rates of around 94 percent. Billing rate increases in recent years are also sharply down from the pre-recession period, with a partner billing rate CAGR of 3.4 percent in 2008–2012 that is well below the 2004–2008 CAGR of 6.7 percent. It is unlikely that growth in billing rates will be restored to pre-recession levels anytime soon. Client resistance to fee increases remains a factor, and in fact, multiyear rate freezes have become a commonplace requirement for appointments to outside counsel panels.

We are noticing as well that law firms not only are providing their clients with more value adds, such as free onsite CLE presentations and lawyer secondees at deeply discounted rates or at no cost, but also are eating more costs than in the past. For example, an increasing percentage of clients are refusing to pay for online research, a trend that started in the financial services sector but has since spread to other sectors.

3. LOW SINGLE-DIGIT PROFIT GROWTH IS GOOD!

Year-after-year double-digit profit increases are a phenomenon of the boom period. They did not characterize the years before that time and certainly do not characterize today's market. As noted earlier, the CAGR for PPEP was just 1.7 percent in 2008–2012. The new definition of a successful year should be just that — PPEP growth in the low single digits.

Unfortunately, many partners who "grew up" during the boom years still cling to the expectation that healthy firms should see double-digit PPEP growth. This state of denial is at least partially responsible for the ever-increasing movement of high-performing partners to new firms. Moreover, firm leaders are getting mixed reviews on how successfully they are managing partner expectations. Unless management becomes better at disabusing partners of the expectation of double-digit PPEP growth, we can expect to see an ongoing exodus of partners firms do not want to lose.

That said, compensation is not the only driver of lateral movement. Even when a firm is underperforming, top partners will stay if conditions are right. In fact, some firms in the post-recession period have weathered significant dips in PPEP with little to no attrition of top-performing partners. Typically, these dips are short-lived, and the firm leadership makes sure to prepare the partnership for a less-than-robust year. Partners are also less inclined to leave a firm with a cohesive, collegial environment, open communication and a well-defined strategic plan. And they are more likely to stay when the firm's rate structure supports their client base. In addition to managing partners' expectations of PPEP growth, leadership should pay heed to the roles these other factors can play in maintaining firm stability.

[5]The Top 20 Firms are sourced from the Citi Annual Survey database and represent the 20 survey participants with the highest 2011 PPEP. The group includes 19 Am Law 100 firms and 1 Am Law 2nd 100 firm.

4. VOLATILITY IS A FACT OF LIFE

In the 2008–2012 period, a significantly higher percentage of firms experienced negative PPEP growth, compared with the pre-recession years. During 2004–2008, just 12 of 79 firms saw dips in PPEP. Following the recession, that number more than doubled to 27, or more than one third of our sample. Average PPEP growth for the sample dropped as well, with the performance of the top and bottom deciles shifting roughly 10 percent downward from the earlier to the later period. In addition, dispersion increased somewhat, with the gap between the highest- and lowest-performing firms widening slightly.[6]

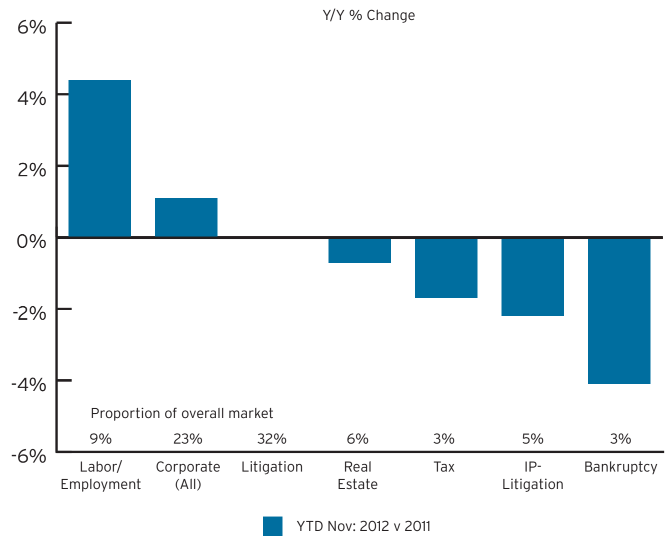
It comes as no surprise that this greater volatility has contributed to a spike in law firm failures. The 21-year period of 1987–2007 witnessed 18 significant law firm failures. In recent years, that rate has almost doubled, with eight significant law firms failing in the last five years.

The increased fluidity of the market for talent adds to the likelihood that additional firms will fail or weaken enough to be compelled to merge with a stronger firm. Top-performing partners at firms with negative PPEP growth start thinking they could do better elsewhere. They are also a prime target for headhunters, who help pave the way for a move. At the same time, in a bid to boost profits, management at these firms starts leaning on underperforming partners to leave. Both tendencies lead to churn and are potentially destabilizing to firm cohesion.

THE FORECAST FOR 2013

Demand for legal services in the year ahead is shaping up to be moderately better than in 2012. Citi Private Bank data show demand to be flat through the first nine months of 2012, and, as shown in Chart 3 below, Thomson Reuters Peer Monitor data[7] indicate that growth in demand (gross billable hours) for the two largest practice groups (corporate and litigation), which together account for more than half of the market, ranged from flat to 1 percent.

Chart 3: Demand Growth by Practice Area



[6]This analysis is derived from two sources: (1) Citi Annual Survey of 148 common firms, 2004-2011; and (2) a sample of 79 common firms from the Citi Flash Surveys: 9mo'04, 9mo'08 and 9mo'12. The 10% of firms with the highest PPEP CAGR for each period (2004-08 & 2008-12) represent the highest performing firms and the 10% of firms with the lowest PPEP CAGR for each period represent the lowest performing firms.

[7]Thomson Reuters Peer Monitor data ("Peer Monitor data") are based on reported results from 116 law firms, including 45 Am Law 100 firms, 41 Am Law 2nd 100 firms, and 30 additional firms.

Although the current demand dynamics do not point to a strong start for 2013, the legal market may improve as the year progresses. Citing government data that show stronger labor and housing markets toward the end of 2012, some observers are predicting moderate economic growth in 2013. The deal market looks a bit brighter as well, especially in the private equity sector, where strong fundraising efforts have firms poised to invest. But even if demand growth in 2013 improves over last year, it's unlikely to revert to the growth levels of the boom years.

The forecast for revenue growth in 2013 looks somewhat weak as well. In addition to soft demand, excess capacity, as discussed in greater detail below, continues to put pressure on revenue growth. Too many lawyers means both lower productivity (billable hours per lawyer) and lower realization rates, as clients continue to press for discounts — and firms continue to give them, in the interest of keeping their lawyers busy. Unless the supply/demand balance is restored, we expect realization to take another hit in 2013.

Expenses once again were up in 2012, although expense growth was more modest than in 2011. Looking ahead, there are a number of forces affecting expense growth, and it is not entirely clear how they will play out. Driving expenses upward: expected growth in headcount from the addition of incoming classes and the de-equitization of equity partners to income partner status. On the other hand, catch-up on delayed infrastructure upgrades that were shelved in the immediate aftermath of the Great Recession served to propel expenses upward in 2011 and, to a lesser extent, 2012. If this catch-up factor has now played out, 2013 could show more moderate expense growth. Two more unknowns at this juncture: the extent to which firms prepaid 2013 expenses at the end of 2012, and whether and how much bonuses will drive up 2013 expenses.

Although the degree of expense growth remains somewhat of a question mark, we anticipate that pressure on revenue growth, combined with expense growth, will continue to squeeze profit margins. As a result, we expect PPEP growth to be in the low single digits in 2013.

Part II
How to Succeed in the New Market

INTRODUCTION

Even in this volatile and challenging market, some firms are thriving as they take Peter Drucker's advice to heart. We have taken a close look at what these firms are doing right — including in-depth conversations with many of these firms' leaders — and noted several important characteristics that differentiate this group. Drawing from our findings, we have identified a number of best practices for success in the new market, and below will focus on three.

1. LISTEN TO YOUR CLIENTS

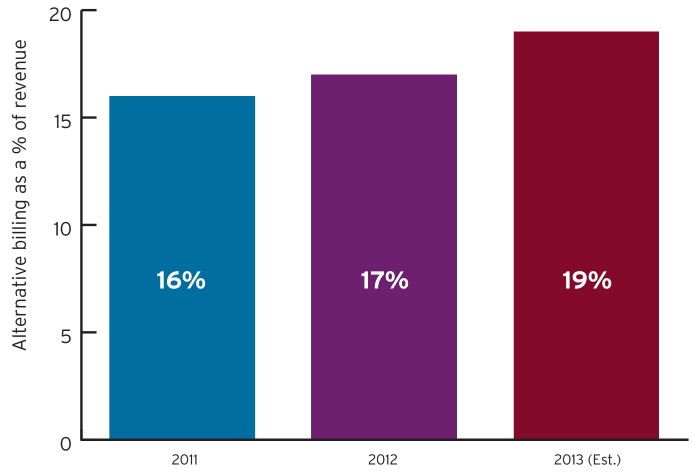
It may seem obvious, but too often, we find that law firms do not take the time to listen to their clients in a systematic or sustained way. Although we have noticed that law firm leaders are spending more time with key clients these days, many partners seem reluctant to seek meaningful feedback, for fear of hearing bad news. They seem even less inclined to shift the discussion to their client's business to learn about strategies, priorities, risk concerns, pressure points and other factors driving their legal spend decisions.

Understanding your key clients' — and prospective clients' — business should inform every major decision your firm makes. Market research is the first priority for a company looking to launch a new product, with good reason. Starbucks waited 23 years to expand to the notoriously fickle New York coffee market. Similarly, a law firm looking to open an office in South Korea should determine whether and to what extent its existing client base plans to do business in that country.

A conversation with your clients can help you gain a better understanding of what is driving their legal spend decisions, including budget and pricing pressures. The legal department may have a mandate from management to cut the budget by a certain percent, or they may have a fixed budget that they cannot exceed. In the former situation, in-house counsel would likely be looking for a cost reduction; in the latter, they would likely be more focused on cost certainty.

In addition to their business drivers, there are also two key factors influencing how clients make their legal spending decisions. Through the use of matter management systems and e-billing software, many sophisticated corporate clients have access to much more detailed data on the cost of legal services than law firms have. In-house counsel may also be working with their company's procurement department, which puts them in a stronger position to demand, develop and monitor alternative fee arrangements (AFAs). As shown in Chart 4 below, the percentage of revenue attributable to AFAs continues to climb.

Chart 4: Trends in AFAs as a percent of Revenue



Source: Citi 2012 Law Firm Leaders Survey

A discussion with your clients can enhance your firm's ability to craft and implement successful AFAs, which are mutually beneficial to your client and your firm.

There are any number of reasons a client will hire a particular firm. Rather than assuming that the market is going in a particular direction or why clients are coming to you (or to another firm), seek to learn from your clients about their business drivers. Listening to your clients will also help your firm to build stronger relationships and shift the discussion from price to value.

2. RETHINK YOUR BUSINESS MODEL

During the boom years, success was relatively easy to come by. With average PPEP growth north of 10 percent, even firms with inefficient, unfocused management mostly were able to get by. It's a different story in the current market, which is marked by fiercer competition, more pricing pressure and record levels of lateral movement. To survive and thrive in today's market, firms should rethink their business model, with a focus on five key components.

Align Strategy and Implementation

The most successful firms in today's market have a clear, thought-out strategy for growth. They have targeted key practices, industries, clients or regions in which they have prominence, and have developed a business plan around those targets. For example, most of the Top 20 Firms (a group that has remained remarkably consistent over the past decade) are considered "go-to" firms in at least one practice area, which usually feeds the firm's other practices. Among smaller firms, a number who have developed and built on niche practices – such as federal regulatory, patent litigation and employee benefits – stand out for their strong performance in the past four years.

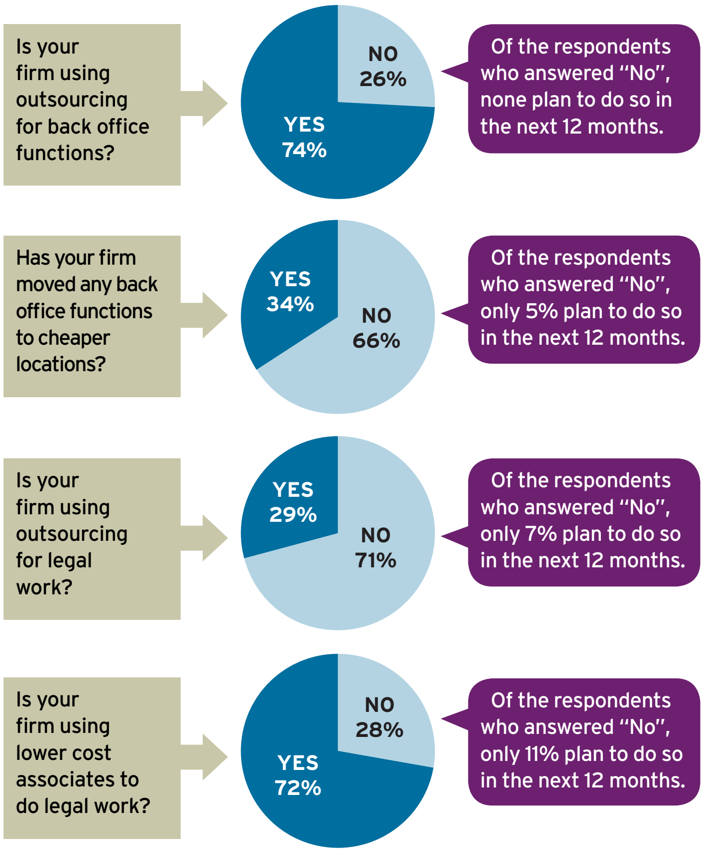
As important as a well-thought-out business strategy is, it is equally important to align strategy with implementation. The disconnect between the two played a critical role in several law firm failures. For example, more than a few firms have suffered the price of expanding too fast. As discussed in more detail below, lateral hiring is another area in which the alignment of strategy and implementation is key. Although lateral hiring can play an integral role in a firm's growth strategy, poor execution of this tactic can prove costly.

Focus on Efficiency

Most law firms reacted to the Great Recession with a spate of belt-tightening, and many are continuing to look for areas where they can cut costs even further. However, without more transformative changes in law firm structure, it is our view that these efforts to control expenses can only be taken so far, and in fact after a two-year dip in the immediate aftermath of the recession, we saw a significant uptick in expenses in 2011 and 2012.

As reflected in Chart 5 below, many firms are embracing structural changes to create efficiencies in expense management that we think make sense.

Chart 5: Cost Management



Source: Citi 2012 Law Firm Leaders Survey

For example, in recent years, several firms have embraced strategies adopted by their corporate clients years ago, and have moved billing, human resources, IT and other back-office functions to less expensive locations in the US, UK, India and the Philippines. Not only are rents and salaries cheaper in these regions, but grouping the teams that perform similar tasks can create efficiencies and produce better results. Following in the footsteps of Orrick (Wheeling, VA), WilmerHale (Dayton, OH), Pillsbury (Nashville, TN) and Allen & Overy and Herbert Smith Freehills (Belfast), Bingham McCutchen recently announced plans to move a number of administrative functions to Lexington, KY.[8]

Other firms are outsourcing functions to outside contractors, and companies specializing in services such as word processing, copying and mailroom duties have become a common sight at larger law firms. The roster of tasks that firms are now willing to outsource is also expanding. Foley & Lardner recently outsourced the work done by its records department to a provider who already handled mailroom, copying and reception duties for the firm. Paul Hastings recently farmed out its hospitality functions, using outside contractors to staff reception areas and conference centers.

Another increasingly popular practice is the outsourcing of routine legal services such as litigation support and basic document drafting to service providers located both overseas and in the United States. The practice has become prevalent enough to prompt the American Bar Association to issue a new rule in August 2012 establishing lawyers' ethical duties to clients when using outsourcing.[9]

We are also seeing more efforts to create efficiencies in the delivery of legal services. Pricing pressure and the growing use of AFAs have produced a sense of urgency around these efforts. In fact, as some firms have learned the hard way, mismanagement of AFA engagements (including miscalculations in fee estimates) can prove costly. Firms have been reexamining the mix of timekeepers in a bid to better manage cost, and we have seen a significant uptick in the use of nonpartner-track attorneys. At the same time, many firms have reduced associate hires. This shift in the makeup of the timekeeper pool provides several advantages, including lower compensation costs and more flexibility in response to changes in workflow. Smaller associate classes may also help in retention efforts, since fewer associates may mean improved development opportunities, and ensure that associates feel more invested in the firm.

Leadership Is Key

If the recent spate of law firm failures teaches us anything, it is that good leadership is critical to success in the current market. While effective law firm leadership is characterized by a number of key attributes, we want to focus on four: transparency, inclusiveness, checks and balances, and tolerance for dissent.

Transparency on major decisions and financial performance matters because it helps gain buy-in from partners, and promotes a more cohesive partnership. A second important feature of effective management is inclusiveness. Well-managed firms ensure that the top levels of management represent the breadth of practices, regions and major offices of the firm. Succession policies should provide for turnover in leadership on a regular basis, to allow newer partners or previously unrepresented segments of the firm to serve on the leadership team in the foreseeable future. An effective leadership structure also typically includes a system of checks and balances. The finance committee and other powerful groups charged with high-level decisions should be accountable to other decision makers, to avoid too much power sitting within a small pocket of the firm. Finally, leadership should be open to dissent, and allow for meaningful debate around controversial issues. Quashing dissent can produce discontent that can result in unproductive or undermining behavior by partners to the detriment of the firm.

[8] All firm-specific references are derived from the public domain.

[9] Resolution 105C amends the comments to ABA Model Rules 1.1, 5.3 and 5.5 to clarify lawyers' obligations when outsourcing work. The Resolution requires a lawyer to obtain the prior informed consent of his or her client in most circumstances in which the lawyer outsources legal services provided to that client.

In the last year or two, the legal industry has experienced a particularly high degree of change in leadership. We have noticed, however, that occasionally a tension exists where a partner who takes over the helm exhibits a reluctance to give up his or her practice. This can present a challenge in today's market, where firms are advantaged by full-time leadership. Firms should also think twice about filling non-lawyer executive roles with partners — or leaving these positions vacant — in a bid to save money. The exponential growth in the size of the average law firm, the globalization of the market, the increasingly complex mix of professionals and staff, and unprecedented competition have transformed the legal industry into a business as much as a profession, and law firms are smart to understand and embrace that fact.

Pay Heed to Culture

At the same time that law firms are grappling with the transformation of the industry into a business, there are elements of a law firm partnership that do make it distinct, and it is important to strike a balance between the two. Historically, the profession was characterized by relatively little lateral movement. This stability produced partners who viewed themselves more as a member of a collective enterprise, rather than as an individual profit center.

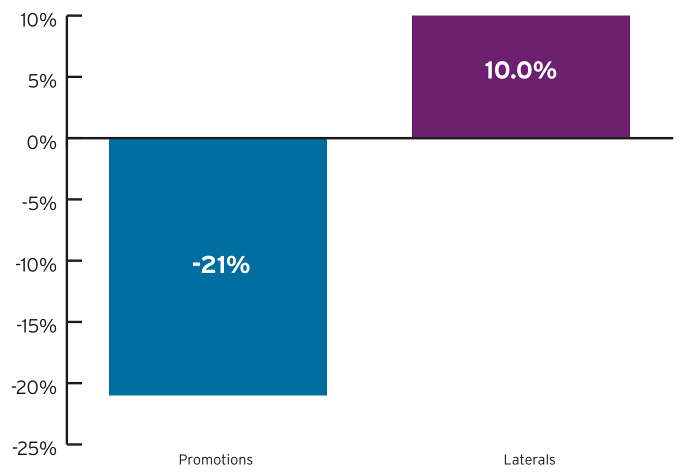
A focus on culture need not come at the expense of profitability. In fact, a common characteristic of the Top 20 Firms is a collegial, cohesive partner culture, with mostly homegrown partners. Any lateral additions are carefully thought through, and equity partner headcount is managed closely.

Law firms discount or ignore firm culture at their peril. For example, the leaders of a firm whose partners pride themselves on their dedication to public service, a culture of collegiality and tolerance, and a commitment to share profits in a fair and transparent manner should acknowledge the importance of this culture to the firm's success so far. Any strategy to grow bigger or become more profitable should be implemented in a way that preserves the best elements of the firm's culture. Otherwise, the firm could end up driving out key partners who were not on board with its growth plans.

Firms contemplating a merger or a major acquisition should always pay heed to cultural fit. Leaders of a newly merged firm should place priority on building a cohesive new firm culture.

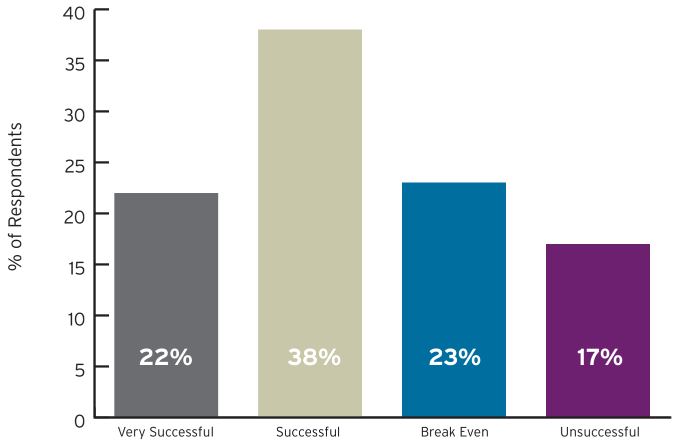
Lateral hiring is another area in which firm culture plays an important role. As our data shows, lateral hiring is more popular than ever. Chart 6 below shows the partner growth strategies of 39 large law firms surveyed in the Citi 2012 Law Firm Leaders Survey. The chart, which compares the percentages of new equity partners attributable to lateral hires vs. internal promotions in 2007 (derived from Citi Annual Survey data in that year) with percentages in 2011, reveals a marked shift in favor of laterals.

Chart 6: Growth in Promotions and Laterals: 2007 vs. 2011



As shown in Chart 7 below, many firms have been disappointed with their lateral return-on-investment.

Chart 7: Lateral Success



Source: Citi 2012 Law Firm Leaders Survey

That doesn't have to be the case. Done right, and with an eye toward firm culture, a lateral hiring program can be a tremendous asset. Rather than simply going after big rainmakers, firm leadership should think carefully about what role a lateral hire will serve at the firm. Laterals should also be carefully and systematically integrated into the firm, rather than being left to fend for themselves once they walk in the door. Another key to successful lateral hiring is transparency and buy-in among key partners and partners of the relevant practice groups, especially with regard to compensation packages. Finally, where there is a heavy reliance on lateral hiring, law firm leaders should pay careful attention to the message this strategy sends to homegrown associates about their career prospects.

Keep Your Balance Sheet Strong

Today, more than ever, financial health matters. With the post-recession drop-off in average PPEP growth, firms cannot count on cash flow to the same extent as in the pre-recession years. In recent years, firms have taken various measures to help keep their balance sheets strong. Bank debt levels have come down and firms have replaced bank debt with paid-in capital from equity partners, as demonstrated in Chart 8 below.

Chart 8: Paid-in Capital Trends

Source: Citi Annual Survey

More paid-in capital means a greater investment in the firm by its partners, which can help align partner and firm interests.

We believe that carrying an appropriate amount of institutional debt to fund firm initiatives can make good sense. However, firms who take on debt must keep in mind that they will have to answer to an additional constituency — the bank — should things head south. For instance, the exodus of a high enough number of partners within a certain time frame can cause a default of a loan agreement.

Taking on some debt may help with a growing concern at many law firms around funding partner retirement plans. In addition to ERISA-approved retirement programs, more than half of the firms who responded to the Citi 2012 Law Firm Leaders Survey have some form of traditional pension plan for their partners, with almost all of these plans unfunded or partially funded. With PPEP growth hovering in the low single digits and a baby boomer generation that is aging into retirement, the time is ripe for firms to take a long hard look at their pension funds, so that a firm's younger partners are not unduly burdened. Also, nothing is less appealing to a merger partner than a major pension liability. Given that the cost of borrowing is at a historical low, it's a good time to consider using a loan, in combination with the capping of a pension liability. A loan that is invested in a conservative, but higher performing portfolio can help fund pension obligations.

3. DIFFERENTIATE YOURSELF

Over the past year, we have noticed a renewed interest in branding, with firms looking to differentiate themselves in today's highly competitive market. However, we caution law firm leaders not to put the cart before the horse, and embark on a branding campaign before settling on a business model and strategy for the coming years. An effective brand reflects the promise a firm makes to clients, both existing and prospective, which in turn derives from the firm's business model.

Firms are embracing various tactics to differentiate themselves. Some have opted for the traditional boutique approach by focusing on a legal practice such as employee benefits or regulatory work. More and more firms are taking their cue from their clients and other professional services firms and structuring their services around industries. Clients today are looking for highly specialized expertise — not just a patent litigator, for instance, but a software patent litigator — and in response, firms have been building their capabilities, or repackaging existing capabilities accordingly.

Globalization continues apace, with mega-firms on the upswing in a wave of cross-border mergers and combinations. In March 2012, China's King & Wood and Australia's Mallesons Stephen Jaques combined to form the 1,800-lawyer firm of King & Wood Mallesons. Also in 2012, SNR Denton, Salans and Fraser Milner Casgrain announced a three-way combination to create a 2,500-lawyer firm to be called Dentons. And UK-based Norton Rose continued along its dramatic growth path by combining with Fulbright & Jaworski in mid-2013, resulting in a 3,800-lawyer firm.

One of the interesting things to note about these recent announcements is the trend toward combining global and industry-focused strategies, providing a broad global platform to exploit sector-based strengths. With the global space getting more and more crowded, a global footprint is no longer enough of a differentiator, and mergers that build on prominence in a particular industry may represent the next phase in cross-border combinations.

CONCLUSION

In summary, we expect that the trends of the past four years will continue into the foreseeable future. Demand, revenue and profit growth will be modest, although overall potential for increased demand exists as financial markets settle down and the economy strengthens. Law firm leaders would be wise to draw from the lessons of the prior four years in leading their firms into the future. They can no longer rely on a rising tide that lifts all boats. In fact, the tide is out. And to paraphrase Warren Buffett, it's only when the tide goes out that you discover who's been swimming naked. Don't get caught swimming naked.

That said, while law firms will continue to face some tough challenges into 2013 and beyond, history has shown that the legal industry excels in adjusting and adapting to a changing environment. As always, we stand ready to assist our clients in meeting the challenges of today's market.

Important Disclosures:

1045873 01/13