BUILDING TOMORROW™

A perspective on the legal market

The 2012/13 year in review, the first half of 2013/14, and what lies ahead

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Contents

Foreword from James Tsolakis

The importance of the legal profession to the UK economy continues to grow as the economic fortunes of world economies stabilise and the velocity of global trade and capital flows begin to show modest signs of accelerating.

Despite recent challenges confronting the general economy, the legal sector in the UK has again demonstrated its resilience and ability to withstand adverse business conditions, and emerge stronger for the challenges presented by that experience. The UK and London in particular, continue to be a magnet for increasing investment in the legal sector. Foreign headquartered firms persist in entering the UK and at the same time the domestic market is experiencing a transformation as firms capture scale through consolidation, new firms commence business, new entrants from outside the legal sector build alliances to allow them to invest and participate in the sector, and innovative business models emerge for the delivery of legal services in the UK.

At the same time, we can take great pride in the significant position the UK legal profession occupies on the global stage. Our firms have continued to build their businesses and networks into the major global economies. This leading position, in both the mature and emerging economies, places UK law firms in a preeminent position as the legal adviser of choice on the major transactions driving economic activity in the global markets.

As Head of the Legal Services business at The Royal Bank of Scotland, I am delighted to share with you my latest report on the legal sector with my unique insights and perspectives on the profession. This is based on extensive research and analysis of the sector and combines with the vast depth of knowledge and experience we have built in banking the legal sector for many years through a dedicated team of professionals focused exclusively on the legal profession.

The UK legal sector continues to be an extremely important sector within the RBS UK Corporate and Institutional Bank. We have a strong market share in the legal sector, and a long and proud history as bankers to the leading law firms in the UK market. We continue to grow our business both domestically and outside the UK through our demonstrable and proven commitment to the sector, actively supporting the growth and development of the UK market and the rapid globalisation of the legal sector.

As Head of the Legal Services sector, I thank you for the banking business we deliver your firm through our dedicated and focused legal sector global coverage model. As a measure of our commitment to our legal clients, it gives me great pleasure to provide you with the analysis and findings within this report. Our focus on our clients and leadership in the sector is unwavering, and I commit to continue delivering the legal profession leading banking products and services in addition to cutting edge research and commentary on the profession. I hope you enjoy this report.

Before beginning, plan carefully"

Marcus Tullius Cicero, (BC106-43), lawyer, philosopher, politician, poet.

About James Tsolakis

The author, James Tsolakis, is the Head of Legal Services within UK Corporate and Institutional Banking at The Royal Bank of Scotland.

James has global responsibility for the RBS banking business with the legal profession and personally focuses broadly on the top 100 firms in the UK and global legal markets. James has been a banker to the legal profession for over ten years, working with the sector in the UK, Europe and the United States.

If you have any comments on the contents of this report or would like to have a discussion on any aspect of the legal profession more generally, please contact James on +44 (0)20 7672 1845 or +44 (0)7780 956119 or by email at james.tsolakis@rbs.co.uk as he would be pleased to hear from you.

Executive summary

The legal profession is presented with challenges today, infinitely more difficult than ever before experienced. The global economic crisis of 2008 and the prolonged economic recession which followed were seemingly the nadir for the profession.

I fear however that if market participants accept this view and, sheltered by the early signs of economic recovery, revert to the business practices which pre-dated these events, the consequences for those market participants and the profession more broadly will be adverse in the extreme.

Demand for legal services remains constrained. Accompanied by a continuing level of fee-earner overcapacity relative to the demand for legal services, pressure continues on billing rates, margins and profitability. These pressures look set to continue until market forces better align the supply and demand characteristics of the market to re-establish equilibrium. Meanwhile, market segmentation will accelerate and be clearly defined in terms of the widening distance between market participants measured by revenue and profitability.

In response, many law firms are challenging their traditional business models and seeking different approaches to the organisation and structure of their firms. Most interesting is the increasing focus on executing legal and back-office activities in lower-cost jurisdictions, perhaps within the firm or outsourced to a third-party provider. At the same time, the use of contract staff and paralegals is accelerating. A major and highly desirable consequence of this is the shift of the traditional law firm cost model from a heavy fixed-cost to a much more variable-cost model.

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The current market conditions are also driving consolidation in the legal sector. The considerations in favour of consolidation will remain with us in the medium term and therefore the rate of consolidation is well set to continue and accelerate. In the year ahead, we will see more domestic and international mergers. Not all of these will be successful and some will be borne out of weakness. However, the advantages available in the completion of successful transactions combined with the commercial necessity in remaining relevant to clients, will be a catalyst for increasing levels of merger activity and international expansion. At the same time, lateral hiring looks set to accelerate both domestically and internationally in the year ahead. However, this response to the growth challenge is ever more risky, recognising the cost of the process and historical failure rates across the sector.

Over the next few years, to remain competitive, law firms will need to better understand their businesses. They will develop better skills and techniques in cost accounting, project management and workflow analysis. They will also have increased leverage at the lower-end of the fee-earning ‘pyramid’, meaning that paralegals and associates will have more responsibility for instruction execution, thereby delivering a more cost-effective service. This will all serve to positively respond to client needs, deliver a more flexible and nimble variable-cost based law firm business model, and drive down the cost of delivering legal services.

Information technology will be a major focus of investment for law firms in the year ahead, and is seen as a significant source of competitive advantage by a majority of law firms.

Finally, new entrants to the legal sector will be a feature of the market in the year ahead. These will take the traditional form coming from both the UK and abroad. However, we will also see some radical new law firm businesses and structures, many backed by expertise, resources and capital provided by non-lawyer investors.

The key to success for all market participants in the year ahead will be driven by the extent to which law firms can continue to remain relevant to clients, respond quickly to their changing needs, provide high quality advice both cost effectively and efficiently, while managing the firm to deliver long-term stability and continuity through multiple business cycles.

1. The economic and business environment

There are encouraging signs that the economic fortunes of the UK are about to recover, with consecutive quarters of slow growth and declining unemployment.

But the long-term outlook for the legal profession is still far from certain, and so, notwithstanding early indicators of improving economic conditions, law firms would do well to continue to make efforts to challenge their organisation and structure, business model, drivers of success, points of differentiation, financial management practices and cost base.

Key economic indicators include:

- Signs that the Eurozone and UK economies are recovering as both report slow growth. UK economic output rose by 0.7% between October and December, according to figures from the Office for National Statistics (ONS), which builds on a 0.8% GDP rise in the July-September period which was the best quarterly performance since 2010.
- At 7.7% (according to ONS figures), UK unemployment appears to be falling slightly faster than forecast against a backdrop of a robust recovery that is proving stronger than expected. The Bank of England committed in August to keep interest rates on hold until unemployment hits 7% - something it forecast would take three years - unless inflation threatens to get out of control or there are major risks to financial stability.
- According to December's Markit/CIPS Purchasing Managers' Index, UK manufacturing grew for the ninth consecutive month in December and recorded its strongest quarterly performance for two-and-a-half years. Growth in output and new orders remained close to August's 19-year high, though export business growth remains weak.
- The ONS reported that the UK inflation rate has continued to decrease month-on-month from 2.7% in September to 1.9% in January 2014.
- The Eurozone has reported four consecutive months of business growth. The Eurozone emerged from recession in the second quarter of 2013 when it grew by 0.3% following a record 18 months of economic contraction. However, European Central Bank (ECB) president Mario Draghi has said that the recovery in the bloc remained "weak, fragile, uneven".
- The German economics ministry said in its autumn forecast that GDP would expand 0.5% in 2013 and 1.7% in 2014. The country's unemployment rate is set to hit 6.9% this year and fall to 6.8% in 2014 – far below the 12% reported by the Eurozone. This relative strength is evidenced by favourable performances from the German offices of major law firms.
- Spain is on the road to economic recovery, but it is recovery of a joyless as well as jobless kind. After nine successive quarters of declining output, Spain returned to growth in the three months to September 2013.
- Portugal's gross domestic product contracted by 1.4% in 2013. According to Portugal's National Statistics Institute, its economy expanded in the final quarter of 2013 by 1.7%, meaning that the country is officially out of recession following 13 consecutive quarters of negative growth. Portugal's government has also raised its 2014 growth forecast to 0.8% from 0.6%. In contrast however, Greece's economy shrunk 3.9% in 2013.
- Standard & Poor's says the 16-day US shutdown over negotiations to control national debt in November has cost the US economy US$24 billion (£15 billion), shaving 0.6% off economic growth in the December 2013 quarter.

UK unemployment

At 7.7% (according to ONS figures), UK unemployment appears to be falling slightly faster than forecast against a backdrop of a robust recovery.

The economic forecasts may only be reporting expectations of slow growth for the first-half of 2014 – but the figures show that a recovery is underway.

- The US shutdown has not pleased investors, particularly foreign nations like China, which hold US sovereign debt. The yield on short-term US Treasury bonds – the amount the US government pays to investors to hold US debt – has risen, increasing US borrowing costs and indicating that global investors see increased risk in these securities combined with displeasure over Washington wrangling.
- China's gross domestic product increased by 7.7% overall in 2013. Economic growth picked up pace in the July-to-September period, the first rise in three quarters, according to the country's National Bureau of Statistics. The world's second-biggest economy grew 7.8% in the third quarter of 2013 (and 7.7% in the fourth), up from 7.5% expansion in quarter two. The official figures also showed growth in industrial output, retail sales and fixed asset investment.
- Growing optimism over the global economy is likely to lead to a marked pick-up in the number of mergers and acquisitions over the coming months. In its half-yearly report into the M&A sector, consulting firm Ernst & Young said it expects both the volume and value of deals to increase over the coming year, with 35% of companies surveyed likely to pursue acquisitions compared with just 25% a year ago. The more favourable backdrop is attributed to growing optimism among executives.
- Global equity markets are likely to have a lacklustre performance in 2014 compared to the rally that investors enjoyed in 2013. The key reason for this weaker outlook is the moderation of asset purchases by the US Federal Reserve. Bond buying by the Fed in the years following the global financial crash has caused US Treasury prices to surge, resulting in a drop in yields. Investors have therefore shifted their asset allocation to equities while interest rates remain low. But with the Fed moving towards tapering of quantitative easing, and valuations in most equity markets slightly above their ten year averages, there is the likelihood that markets will respond. As liquidity is removed from the global financial markets, this will eliminate some of the liquidity which provided strength to equity markets during 2013.

The economic forecasts may only be reporting expectations of slow growth for the first-half of 2014 – but the figures show that a recovery is underway. What this means for the UK's legal sector is difficult to judge, but there are grounds for cautious optimism: it should result in law firm clients undertaking more investment activity seeking to expand domestically and abroad, and M&A activity should increase. This will have a positive knock-on effect in the number and type of legal services that they require.

On a more cautious note, companies' efforts to cut legal spend are unlikely to suddenly change at the first signs of economic recovery. Clients will still be looking for value-adding services at sensible prices, so law firms can continue to expect pressure on fees, service delivery, and a push for greater transparency on costs – particularly the rates being charged.

China's economic growth

The world's second-biggest economy grew 7.8% in Q3 2013, up from 7.5% expansion in the previous quarter.

2. Demand for legal services and revenues

There is no doubt that the market for legal services has been tough post-recession.

According to research by Legal Week, for the 2012-2013 financial year, the top 50 law firms have seen their average profits shrink by 0.5% while average turnover has risen by 6.9%, indicating that law firms are feeling margin pressure and finding it difficult to manage their costs within the fee structures being demanded by this market. Therefore, law firms need to be relentless in their pursuit of margin management which is constantly under threat from both revenue and expense pressures. Recognising that profit growth is not increasing at the same rate as turnover, the pursuit of higher value instructions combined with effective cost management must be continuing themes driving law firm strategy and future profitability.

According to Law Society figures, total turnover is estimated to have fallen between 2011 and 2012 to £25.4 billion (following only a marginal increase between 2010 and 2011) as the economy struggled through a double-dip recession. These difficult market conditions have necessarily resulted in law firms restructuring, in many cases quite aggressively. As a result, the market has seen dozens of staff, both lawyers and support roles, eliminated from the Top 100 law firms during the course of the year. Smaller firms have not been immune from this trend and have also suffered job losses. The number of training contracts offered in England and Wales has also fallen to the lowest level since 1998/99.

As we progress through 2014, it looks like the market is turning a corner. In February 2013, the Law Society produced a report forecasting that the UK legal services market is set to power out of the recession with annual growth of 4.2% from 2015.

The Law Society study shows that law firms in London and elsewhere in England and Wales are winning an increasing share of a growing global market, bolstered by a strong international reputation and a highly qualified and professional workforce. With strategic international expansion and regulatory changes permitting increased external investment, some firms are well placed to win an even larger share of this growth.

However, many in the legal sector would claim that the Law Society's growth estimate is over-optimistic, particularly for traditional high street law firms which face a less rosy picture. While these firms have proved remarkably resilient over the last few years, even when their traditional sources of income – conveyancing residential property and representing legal-aid funded clients – have halved, continued pressure through increased competition resulting from the Jackson reforms and static fees is likely to result in some significant restructuring and refocusing at this end of the market. This will be an imperative for firms to survive and compete against bigger firms providing high-volume, low-cost legal services now backed by investors with substantial financial resources such as is available in the new ABS environment. There are also likely to be some casualties in this end of the market as some small firms, absent any growth or succession plan, may not be sustainable in the longer term and simply close for business.

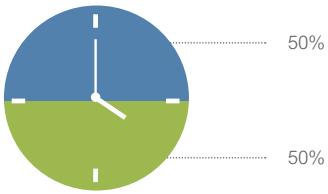
For the sector generally, however, there are several reasons for this projected upswing in growth and the profession remains optimistic. Despite pressures on fees, several recent surveys have shown that the number of chargeable hours and rates have both gone up. A recent RBS survey has found that over 60% of firms expect to increase fees over the next 12 months, and 50% expect to increase the number of chargeable hours, with more than 90% of respondents overwhelmingly expecting billing rates to stay the same.

Fees

Change in fees in the next 12 months

Chargeable hours

Expected utilisation in the next 12 months



Billing rates

Change in billing rates in the next 12 months

Key

Decrease	(<-5%)
Stay the same	(+5% to -5%)
Increase	(>+5%)

The sector will also continue to benefit from the financial pressures and activity levels experienced by in-house legal teams. In many cases, General Counsel have continued to be under severe cost constraints and have shed staff: many in-house legal departments have staff resourcing constraints. This means that they are unable to process all the work and deliver the advice required in a commercial climate of increasing regulatory and compliance oversight. This has helped drive the emergence of contract legal services businesses. This trend is set to continue with the emergence of new entrants providing these services combined with the growth of existing market participants. The key deliverable which will underwrite the success of these firms and their clients is the flexibility which it introduces to the business model, and particularly that of a law firm. It is clear that successful law firms of the future will have greater agility, and through this, will develop a lower and more variable cost base aligned to the level of activity in the firm. A clear demonstration of this will be the use of variable fee-earner populations which can be flexed according to levels of client demand.

Another factor that is progressively changing the law firm model and driving profitability is law firms' increased reliance on paralegals. These 'non-solicitor-lawyers' are doing more work, and increasingly will do more of what solicitors formerly undertook themselves. They generally cost less than solicitors, and billing rates suggest an attractive margin from this fee-earner population while delivering lower costs to clients. This development is well established and the trend is set to continue with over 30% of firms planning to grow their non-legally qualified fee-earner population next year.

Law firms have already been rapidly building 'process units' both in their main locations and in cheaper sites around the UK. Large City law firms are also sending work to sub-contracted law firms in regional centres that have large paralegal teams. Legal process outsourcing (LPO) companies are building paralegal teams and seeking to gain work from banks and corporates. Alternative business structure (ABS) law firms are also growing paralegal teams that can handle commoditised matters within highly systematised frameworks.

Fortunately, the demand for legal services is still evident – and well-established traditional law firms will continue to be the beneficiaries. However, competition for the work available remains intense and therefore domestic growth shared uniformly across the market is not expected. It will be some time yet before firms experience a strong volume-driven upswing in some core practice areas and key profitable areas of practice, notably M&A work. The legal market will therefore continue to segment according to law firm turnover and profitability, with the distance between firms in these various segments widening. As a result, this will almost certainly prompt more law firms to continue to pursue merger opportunities and look overseas to expand their revenues.

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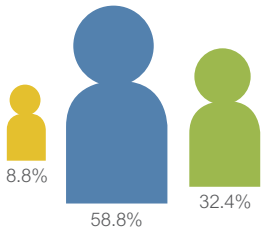
Non-legally qualified fee earners

Change in numbers in the next 12 months



Key

Decrease	(<-3%)
Stay the same	(+3% to -3%)
Increase	(>+3%)

One serious underlying structural challenge for the UK legal services market is that it suffers from over-capacity. Demand dynamics have not been kind to the legal profession since 2008. The absence of a strong rebound in the economy – and therefore weak demand for legal services – continues to constrain robust growth in the domestic market. The size and shape of the supply side of the legal market continues to develop, and is characterised by ongoing growth in the number of market participants. From the retail end to the largest international firms, the UK and London market in particular is a magnet for investment in the legal services sector. It continues to attract and absorb many new entrants who enjoy relatively low barriers to entry. These include both UK domestic firms, some of whom exist by virtue of the equity provided by non-lawyer investors, in addition to foreign headquartered firms which subsidise local operations and seek to carve out a slice of the UK, and especially the London, legal market.

An analysis of chargeable hours across the sector, together with the RBS survey results, suggests there is too much capacity for the volume of work currently available. Half of the RBS survey respondents indicated that they do not expect an increase in chargeable hours in the ensuing year. If these estimates are realised, it will not be possible for historical levels of profitability across the sector to be maintained having regard for the continuing pressure on billing rates and some clear inflationary pressures emerging in law firm cost structures, which will only serve to put pressure on margins already under some stress.

As mentioned above, it is likely that the market will continue to segment on many levels, and one of these is the profitability and financial results which firms deliver. Clear separation between market segments, already evident in the legal sector, will continue to widen as firms cluster within segments or bands which define their market profile, business credentials and reputation, and financial characteristics and success. In many ways, as has occurred in so many parts of the economy, the legal profession is going through a period of adjustment and normalisation following a prolonged period of abnormal and unsustainable growth that ended in 2008.

The legal market will therefore continue to segment according to law firm turnover and profitability, with the distance between firms in these various segments widening

Following the economic downturn, which burst the bubble on the inflated value of many asset classes in the economy, similarly the value of legal services has slowly been reassessed and repriced to levels which are more consistent and closely correlated with long-run inflation adjusted averages.

It is clear that the low growth evident in the market over recent years has forced firms to grow their businesses by capturing market share from competitors. Much of this has been driven through lateral partner hiring. A growth strategy that is based on recruitment as a means of capturing market share by poaching instructions and clients is both high risk and expensive. As an alternative approach, there has been a noticeable improvement in some firms' ability to capture market share by developing a more focused approach to client management and relationship development. However, the profession is still relatively unsophisticated in the implementation of these techniques and the execution of these strategies. The lower risk, lower cost and higher returns available from capturing business from existing clients is compelling. It is likely that the legal profession will embrace these principles more enthusiastically in the UK and abroad, as the advantages are better understood and partners and business development executives become more comfortable and proficient with the skills involved.

One serious underlying structural challenge for the UK legal services market is that it suffers from over-capacity.

3. Merger activity and consolidation

Legal sector consolidation will continue to drive growth in both domestic and international law firms in the medium term. Over 70% of respondents to the RBS legal survey expect the rate of merger activity to accelerate in the next 12 months.

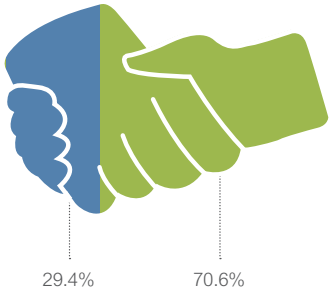
The result of this merger activity will be to accelerate the changes occurring in the structure of the legal profession. Notably, the size and scale of firms in the top 50 as measured by turnover will continue to increase at an unprecedented rate. These firms will therefore represent a greater proportion of the total market for legal services. This will in turn provide new capital and resources to continue driving changes in the law firm model. It will also accelerate the resource, and in particular, fee-earner allocation and reallocation choices which are required to respond to client needs and market forces.

The appetite for mergers exceeds the current level of transactional activity. The underlying demand for consolidation is building strongly and is being driven by many factors including:

- Slow organic growth in the domestic UK market
- Pressure on law firm margins
- Building a deeper and better client base in new jurisdictions
- Creating a wider geographic footprint to service clients in more jurisdictions
- Building ancillary legal services
- Creating joint ventures with business partners outside legal services, now possible using alternative business structures
- Rapidly building scale in growth practice areas or practice areas with a sector focus
- The opportunity to capture economies of scale
- The attraction and financial benefits of spreading back-office and infrastructure costs across a larger population of fee earners

Mergers

Expected merger activity in the next 12 months



Key

Stay the same	(+5% to -5%)
Increase	(>+5%)

However, a danger of the healthy appetite for mergers is that poorly conceived transactions which are not value accretive may go ahead. These may not be founded on solid strategic objectives, well formulated business plans and sound financial principles. The absence of such well considered planning and due diligence provides many reasons why such transactions are likely to be flawed. This will certainly be the case if fundamental weaknesses in either firm are not broached and eliminated before the transaction is consummated, or actively managed and eliminated through the merger integration process. When such mergers proceed, they will therefore fail to deliver the value identified when they were conceived, and the benefits to clients – which should be central to any merger transaction – will not be realised.

Some fundamental obstacles will nevertheless continue to hinder legal sector consolidation. These include:

- Profitability differentials
- Compensation models
- Unfunded pension liabilities
- Liability differentials and other undisclosed liabilities
- Premises costs and overhang
- Rationalisation and integration costs
- Cultural principles and differences
- Equity management requirements
- Capital management issues
- Management structure and corporate governance principles
- Systems and technology differences

These are some basic principles and commercial issues which cannot be overlooked and indeed must be confronted in justifying, supporting and delivering the business case for a successful merger transaction. Inevitably, in delivering a positive merger conclusion, some difficult decisions and resulting pain will be required to capture the value available which makes the transaction attractive to participants and stakeholders.

A danger of the healthy appetite for mergers is that poorly conceived transactions which are not value accretive may go ahead.

4. Profitability and capital structure

The fortunes of law firms have been mixed over the course of the past financial year. Of the top 50 law firms as measured by revenue, Clifford Chance boasts the largest revenues at £1.271 billion, but this actually represents a 2.5% drop on the previous year. DWF experienced the largest increase in revenue growth (84.5%) for the same period.

According to research by Legal Week, only ten out of the top 50 firms saw their revenues decline: LG seeing the biggest change with -7.5%. Slaughter and May had the highest average profit per equity partner (PEP) out of the top 50 law firms. Berrymans Lace Mawer, on the other hand, had the lowest PEP average. Fortunes outside the top 50 – meaning the legal sector at large – are naturally more mixed, with the outlook for three-to-five partnership firms being gloomy.

While the market may still be tough, law firms are confident that profitability will go up over the course of the next 12 months. According to the RBS survey, almost 60% of respondents thought their firms would be more profitable next year, with 38% predicting profitability at similar levels. Slightly over 60% of respondents said that fees would also increase next year, while 32% thought they would remain the same and 6% predicted a decrease.

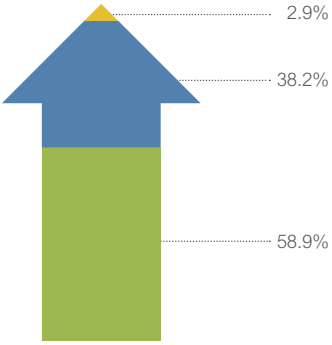
Law firms have experienced a difficult year for margin management in 2013. More aggressive attention and proactive management of margins is evident in some firms but absent from many. Most of the top 50 law firms have increased their turnover in the past year, but profitability has not kept pace. According to research by Legal Week, the average growth in turnover for Magic Circle firms for 2012-2013 was 1.5%, while average profit growth was only 1.1%. This highlights the difficulty of margin management, and this will come under increased pressure as clients demand more predictability on costs, capped fees and other alternative fee arrangements. Firms are therefore faced with the problem of how to maximise their profitability, and two obvious choices are increasing in popularity: better disaggregation of legal instructions, with law firms developing the systems and technology to price and budget work more thoroughly embracing the use of project and work-flow management techniques, and the increased use of paralegals to carry out a wider range of activities which support the legal process. If firms are not proactive in understanding these principles and delivering to clients in this way, they will lag their competitors and be led to this conclusion by competitive pressures and clients who have a need for greater value and transparency of pricing methodology. There is already clear evidence of firms adopting these principles, developing the required knowledge to understand their business and deliver legal services to their clients having regard for these issues. Those firms that do not recognise or respond to this market development will underperform against client expectations and suffer the consequences.

The continuing pressure on billing rates and some clear inflationary pressures emerging in law firm cost structures will only serve to put further pressure on margins already under some stress, and cannot be ignored. If the RBS survey results for expected billing rates and expense increases is realised, it will not be possible for historical levels of profitability across the legal sector as a whole to be maintained.

The expectations of a majority of firms for increasing profitability are difficult to reconcile with the financial trends in the sector. Steady levels of fee income delivered against a back drop of continuing rate pressure and increased costs will result in continued stress on margins which risk further contraction. Nearly a quarter of respondents forecast that salaries will go up, while no one believes they will go down. Almost 30% of respondents believe that expenses will continue to rise, with nearly two-thirds expecting that they will largely stay the same. On the basis

Profitability

Change in profitability in the next 12 months



Expenses

Change in expenses in the next 12 months

Key

Decrease	(<-5%)
Stay the same	(+5% to -5%)
Increase	(>+5%)

of these results and market expectations, firms will be unable to deliver the expected growth in profitability.

Firms still continue to battle with rising expenses and their responses take many forms. Many are actively taking steps to review processes that could be performed more cost-effectively by juniors or paralegals, outsourced to an LPO or LBO provider or executed in a lower-cost jurisdiction either onshore or offshore. Many examples are now emerging of all these practices, reinforcing this as a defining period in the history of the legal profession with profound changes occurring in the organisation and structure of law firms and the delivery of legal services.

The problem firms face is that three of their biggest expenses are largely fixed – staff salaries (including profit payments to partners), premises costs, and professional indemnity (PI) insurance premiums. A key to financial success for law firms of the future will be to increasingly shift this largely fixed-cost base to an increasingly variable profile.

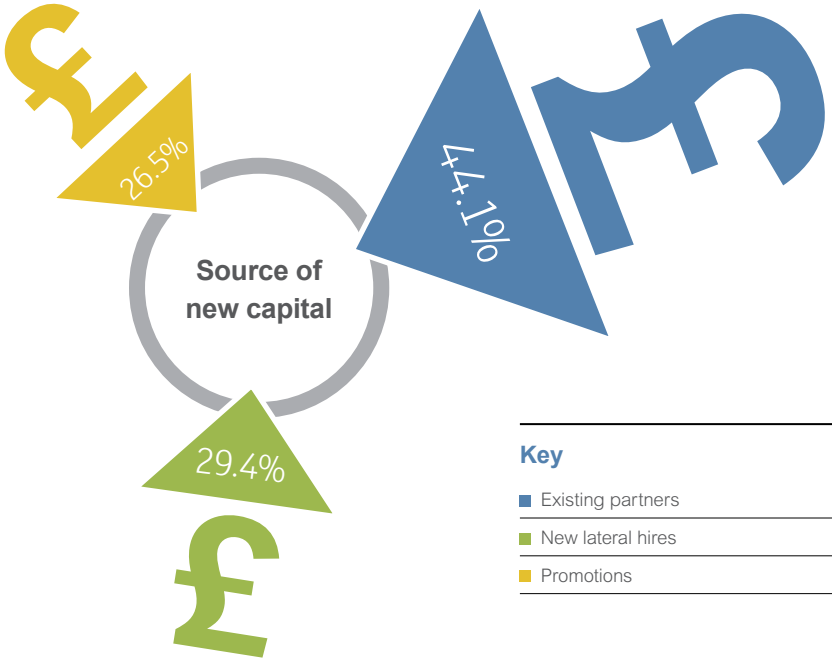
Meanwhile, the sustained rise of the largely fixed-expense base will continue to erode margins and provide a regularly recurring call on cash. Cash flow management must be a priority for law firms. Recent examples of law firm failure illustrate the risk of firms adopting a cavalier and reckless approach to managing cash without regard for prudent boundaries. Cash needs to be managed carefully and with a relentless focus and dedication to shrinking the billing and collection cycles. Some consideration must also be given to the potential for shocks to the economic and financial systems, and the impact of these events. If such shocks were to occur, they may result in severe disruption to historical cash flow behaviour and working capital cycles. Prudent financial management dictates that liquidity alternatives including back-up cash and credit facilities are available to provide firms with financial flexibility in the event that these circumstances arise.

There is evidence that firms intend to take tighter control of their working capital in the coming year. The RBS survey results forecast a 5% reduction in WIP and debtors lock-up. If this reduction in lock-up can be achieved, it would make cash available across the profession as a whole of slightly over £600 million. While the ambition is to be very much applauded, some material changes in billing and collection culture will need to occur in order to bring this to fruition. As a reflection on the improving economy and the quality of debtors, of the firms surveyed, 20% are expecting a decline in bad debts in the year ahead.

According to our survey, 44% of respondents said that they expect to introduce new capital next year through their existing partners, while 29% said that they intended to increase capital through new lateral hires. The remaining 27% intend to raise the capital through promotions to the equity, and advancement to more senior levels within the equity.

A key to financial success for law firms of the future will be to increasingly shift this largely fixed-cost base to an increasingly variable profile.

Capital contributors



Of those firms raising capital next year, 56% say that it will be sourced from partners borrowing from banks, while only 6% said that it would be the firm that would be borrowing the cash. Some 20% of all respondents said that new capital will come from profit retention – which is increasingly visible as a capital accumulation technique in contrast to the full profit distribution model.

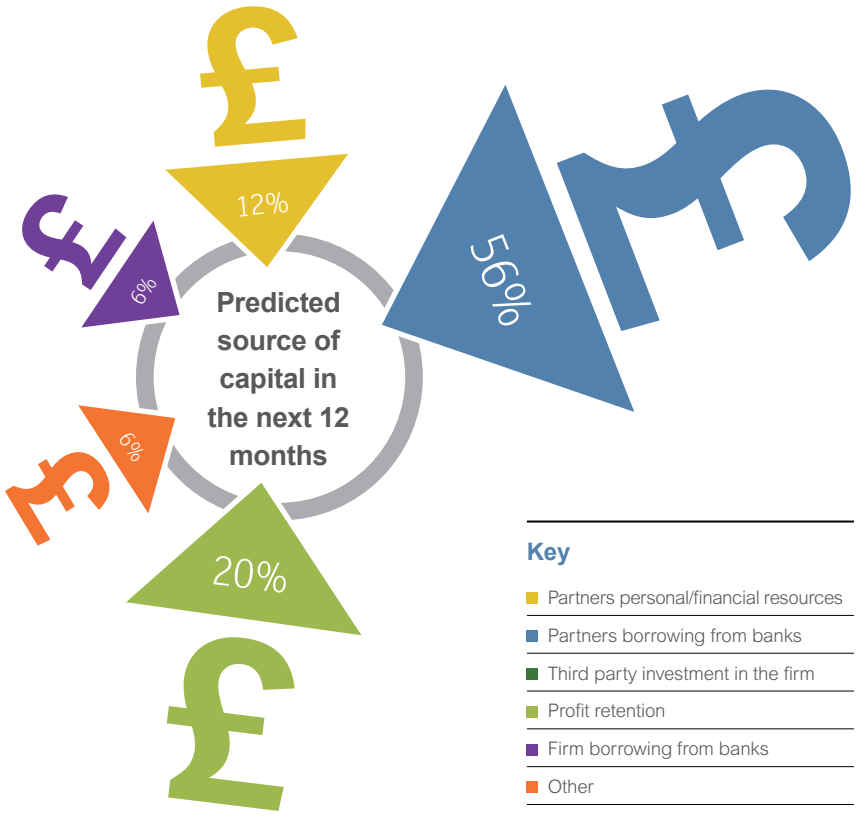
In fact, the full distribution model where all profits are distributed to equity partners the following year has been badly exposed since 2008, because it is not sufficiently flexible to handle immediate or emerging financial obligations. The ability to reschedule current debt repayments or re-structure other long-term financial commitments – such as office moves and refurbishments, premises leases and IT replacement needs which are subject to contractual arrangements – may be very limited.

Debt levels at the top UK firms by revenue have risen to £185 million compared to £138 million in 2011. Furthermore, according to our research, almost 10% of firms expect their level of debt to increase over the year, while slightly over 20% are planning for a reduction.

It is evident that firms need to plan carefully for the changing business environment and at the same time ensure that financial plans reflect the business goals and strategies being pursued, together with the tactics being rolled out for delivery of the business plans. Initiatives such as cutting costs, investment in IT, domestic and international growth, and lateral partner and team hires are set to be a significant drain on financial and management resources. Many firms are embarking on such strategies without a full business and financial plan to support these initiatives, and are therefore responding reactively to the changing environment and resulting business outcomes. These require a strong focus of management attention to ensure a proper redirection of financial resources towards new investment opportunities.

Firms should have detailed business and financial plans to articulate their strategy and financial implications. The financial plans should be subjected to some stress testing to determine and isolate the greatest vulnerabilities to the firm. In the current environment, this plan subjected to stress factors often demonstrates the need for retention of some of the profits year on year to create a buffer should the firm need to call on finances to fund expansion, new offices, debt repayment, lateral hiring of individuals and teams, or other emergency needs in the event of a future firm-related or systemic financial crisis.

Capital sources



5. International growth – opportunities and risks

It is little surprise that UK law firms are looking for opportunities to expand their business abroad. The increasingly competitive domestic market fails to demonstrate material growth. The market faces growing pressure from clients on fees, combined with a squeeze on margins through rising costs. In our survey, 60% of firms questioned said that they had plans to expand abroad during the year ahead.

For those firms that want to access foreign markets, there are three options available: open 'greenfield' offices from scratch; merge with or acquire a local law firm or team; or form a partnership or alliance with local firms.

Over the past few years, the leading international law firms have set up entirely new offices throughout Europe, the Middle East and parts of Asia to serve their international clients active in these markets, and in some cases to attract local businesses that may be expanding internationally.

Many have also merged with local firms to gain access to a new client base. Eversheds' 2011 merger with Middle Eastern law consortium KSLG has given the firm offices in Iraq, Jordan, Saudi Arabia and Dubai; while also in 2011, Clifford Chance launched in Australia after a dual merger with boutique firms in Sydney and Perth.

More recently, Norton Rose's merger with Fulbright & Jaworski – in operation since June 2013 – expanded its reach to Latin America and central Asia, as well as strengthened its presence in countries like Canada and Russia. In March 2013, Salans, SNR Denton and Canada's Fraser Milner Casgrain (FMC) went live with their three-way merger to form Dentons, creating greater opportunities worldwide to expand its global reach, client numbers and client penetration.

In countries that have more protectionist rules in place, foreign law firms have formed partnerships or strategic alliances with local firms as a way of gaining an entry point and to build a platform from which to expand when regulatory conditions permit.

For example, in February 2013, Linklaters launched its exclusive alliance with South African law firm Webber Wentzel, which gives the firm its first presence on the ground in Africa, as well as access to the Africa Legal Network (and potentially markets like Botswana, Burundi, Ethiopia, Kenya, Malawi, Mauritius, Mozambique, Rwanda, Tanzania, Uganda and Zambia) through Webber Wentzel's membership. In May, DLA Piper entered into a strategic alliance with Indonesian firm Ivan Almaida Baely & Firmansyah (IAB&F) to tap into one of the fastest-growing emerging economies in the world.

With organic growth in the UK legal market severely limited, overseas expansion is a logical development. But success in international markets is not guaranteed. The global landscape is littered with the remains of international expansion, in many cases by significant global firms, where the expansion failed to deliver the expected results and the new office was either dramatically restructured or closed. The international legal landscape has become very crowded, requiring greater discipline by management in validating the merits of international expansion and of new office locations. Therefore firms still need to have a very clear strategy about the types of service they are going to offer in these markets, and the clients they want to attract – opening offices overseas and recruiting personnel is not a quick-fix solution to stave off a lack of growth domestically. It takes long-term commitment – as well as deep financial resources – to establish a presence in an overseas market, particularly in emerging markets where international firms may be barred from providing some services or disadvantaged in bidding against local firms for government-backed projects.

International growth

60%

of firms questioned said that they had plans to expand abroad during the year ahead.

Firms still need to have a very clear strategy about the types of service they are going to offer in these markets, and the clients they want to attract.

The Middle East provides a perfect recent example of a market which exhibited strong economic growth and attractive business prospects for ambitious new law firm entrants. The economic downturn, accompanied by social and political instability, changed the landscape quickly and dramatically. As a result, many law firms significantly restructured and some exited the market completely.

Furthermore, opening new 'greenfield' offices, as well as mergers and partnerships, can be extremely time-consuming, expensive, difficult to integrate and disruptive, with returns on investment potentially years away. There is also a risk of producing no discernible value-add for clients (at least initially). Secondly, there can be a shortage of good local firms to partner with. In the face of such competition, law firms may run the risk of offering more to local firms than they can expect to get in return.
In those circumstances, the merger would be dilutive to the lead firm's brand and its impact in the market

Cultural and local market issues can also cause problems. There are many examples of these issues being the source of underperformance or failure of international expansion initiatives. In addition, issues around client conflicts need to be fully explored ahead of mergers or alliances, as they will also be client visible and a quick source of merger tension and instability.

Firms should also be wary about moving into developing markets that are seemingly vibrant legal markets offering a lucrative source of significant new business. In most cases, these markets will have well developed and highly regarded local firms. Some protection may be afforded to them by the local Bar and regulations. Moreover, these markets may already be well known to large foreign law firms who have been in practice there for many years. Under these circumstances, it will be difficult to dislodge their clients. Moreover, the perceived opportunity will not be invisible to competitors, and other foreign firms may be seduced by the allure of significant business and financial success.

For example, Singapore has been a magnet for foreign firms since the city-state became the preferred destination for international arbitration in Asia following the establishment of the Singapore International Arbitration Centre (SIAC) in 1991. As a result, the market has been well supported with foreign law firms opening new offices. Notwithstanding the significant growth in South East Asia, it seems impossible for all the foreign firms in this market to be operating profitably. Excessive competition has resulted in many instances of aggressive pricing behaviour as firms try to capture market share and build relationships with key clients.

Other classic symptoms of an overbuilt market are evident in the war for talent – with firms chasing too few qualified resources – and demand outstripping supply. In particular, qualified people and quality space is in short supply, resulting in rapid salary and compensation inflation and high and escalating premises costs. These economics are simply not sustainable in the long term. Other key centres such as Hong Kong, China and Dubai exhibit similar characteristics and expatriate benefits also need to be considered for relocating partners and their families. Law firms need to formulate rigorous and realistic plans so as to determine the revenue opportunity of foreign jurisdictions and then consider the expense base very carefully before launching a new office. If required, the amount and duration of any subsidies from profitable offices must be recognised and accepted, with actual performance regularly reviewed against plans.

With organic growth in the UK legal market severely limited, overseas expansion is a logical development.

6. Lateral hiring and talent management

Many law firms have staked a lot of their financial success on lateral hires, hoping that they will bring value to the firm within just a few months. As a result, there is an increased and heavy demand for them, though less activity than in recent years.

In reality, however, it can take 18-24 months before lateral moves begin to deliver successful results measured in terms of generating a positive cash flow. Also, it can be a very expensive proposition, and the majority of firms do not challenge how well these hires will integrate within the firm, or how long they should stay to deliver positive results. Foreign headquartered firms and new entrants are often most challenged by the lateral hiring process.

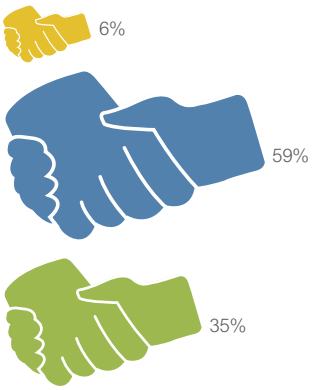
For some time, the domestic growth strategy of many firms has been founded on the recruitment of lateral partners. The aim is not to serve any particular client need or an increasing demand for legal services, but rather as a way of targeting competitors by attracting their key fee earners in the hope and expectation that their clients will follow. When executed well, some firms have achieved great success in delivering domestic growth with this strategy, and capturing meaningful market share from competitors. However, increasing the number of lateral hires is a risky strategy: they may have to be induced with offers of higher pay and rewards; it can take years for the investment in management time, integration cost, and recruitment costs to be recouped; their clients may not come with them because lateral hires may not have the ability to transfer the clients; and the laterals may not easily assimilate into their new firm's culture. Despite the limitations and challenges of successful lateral partner hiring, only 6% of firms surveyed expected fewer lateral partner hires next year, while over 35% expected the rate of lateral partner hiring to increase in the year ahead.

The pent-up demand for lateral partner hires has the potential to be problematic for firms looking to expand by this route. Among many challenges, excessive competition for limited resources will likely lead to inflationary pressure on compensation and margin erosion, management time devoted to the hiring process will be heightened and significant; the quality of due diligence may be compromised to secure the services of the lateral partner being hired; and talent thresholds may be diluted in order to secure the partner in order to build the required scale. These dangers and risks are already emerging and evident in some market segments.

Beyond this, if the increasing demand for lateral partner hires comes to fruition, this surely challenges the upward mobility of senior associates who are looking for promotion to partner and participation in the equity. The inevitable obstacles this presents to

Lateral partners

Growth in lateral partners in the next 12 months



Key

Decrease	(<-5%)
Stay the same	(+5% to -5%)
Increase	(>+5%)

In reality, it can take 18-24 months before lateral moves begin to deliver successful results measured in terms of generating a positive cash flow.

talented associates aspiring to progression to partnership cannot be overestimated. Almost one quarter of RBS survey respondents indicated they planned to grow the rate of lateral associate hiring next year, no doubt to support partner lateral hiring and loosely correlated to that activity.

There is further evidence that the strategy of recruiting lateral hires delivers mixed results. Executive recruitment specialist Edward Drummond told the Law Society Gazette in October 2013 that despite the drawn-out and costly recruitment process involved in senior legal hires, 20% of laterally hired lawyers are no longer with the firm a year after joining, and 50% have left within five years. He added that assumptions are made about the strength of an individual's personal following, but too often clients are not called to test the strength of their loyalty.

However, such evidence is unlikely to affect current thinking that law firm success may be accelerated by recruiting partners who have the potential to bring in significant fees, with fewer than 20% of respondents expecting a decline in the year ahead. Similarly, there is likely to be a big jump in the recruitment of non-legally qualified fee earners, with 32% predicting a rise in their numbers, and nearly 60% predicting that their numbers will remain the same.

However, respondents believe that there will be more shedding of support staff jobs in the sector than those taken on. Of the firms surveyed, 20% plan to decrease support staff roles in the year ahead, while 11% plan to increase support staff headcount. Of all the human resources in a law firm, trainees may be the biggest losers, however, with one-third of respondents expecting a decline in future intake, and none of them expecting an increase.

If law firms want to use lateral hires as a way of increasing their earning potential, they may want to be more rigorous in questioning how these hires will be able to attract clients, and how quickly they can do it, and understand much better the value and quality of instructions they expect to deliver. Otherwise, such recruitment processes can be an expense and distraction that firms can ill afford.

Support staff

20%

Of the firms surveyed, 20% plan to decrease support staff roles in the year ahead

7. Shape of law firms and the leverage model

The past five years following the global financial crisis have challenged law firms – like any other industry – to question their operating models and adapt them to retain clients, fee income and market share. Firms have embraced this challenge with differing degrees of enthusiasm and with contrasting approaches.

With organic growth limited in a declining market, domestic activity has, of necessity, been focused on protecting key client relationships and capturing market share. UK law firms have also actively been exploring merger and acquisition opportunities, overseas expansion, affiliations and networks, and more active use of LPOs.

Yet there is one element of law firms' structure that has changed less rapidly – the leverage model. Leverage works well when the economy is strong and partners can keep their growing number of associates busy with client work, but it is a serious drain on resources when the economy slows. Even a modest drop in revenues can cause a much higher percentage drop in profitability due to the fixed costs (salary and overhead) of having a higher proportion of associates and non-equity lawyers.

According to recent research by ALM Legal Intelligence, since 2008, the number of associates in the 250 largest law firms has diminished by more than 7,000. Some of this capacity has been absorbed through alternative resources and changes made available through new and evolving business models. At the same time, partners are now often engaged more directly in the execution of the client instructions. The risk embedded in this arrangement is that the value of the contribution of partners as key fee earners is diluted. Their earning potential is likely to decline as realisation deteriorates while they contend with work that had once been done by less qualified and experienced staff.

Unsurprisingly, law firms are looking to recruit more paralegals and utilise LPOs as a way of reducing costs and boosting productivity and profitability, as well as introducing a more variable cost structure into the law firm model. It is already clear that smaller firms are able to reengineer their cost-base more quickly than larger firms so as to deliver this outcome. They are therefore progressively, albeit modestly, able to shift their cost-base towards a more variable structure.

Furthermore, over the next few years, law firms will develop better skills and techniques in cost accounting, project management and work-flow analysis. They will also have increased leverage at the lower end of the fee-earning 'pyramid', meaning that paralegals and associates will have more responsibility for instruction execution, thereby managing and controlling costs of instruction execution more effectively. A feature of this change is that firms will carry out better profit analysis of instructions they are accepting and the level of partner involvement needed to complete them. Successful execution of this analysis of instructions will drive greater rewards for both clients and firms, with work completed at keener prices and with better control over margins.

As these changes occur and the shape of law firms changes, it is likely that the relative number of equity partners will decline. Since 2008, we have already seen a slowdown in the number of partners being made up in the UK domestic market. While this will deliver better rewards for remaining partners over time, it will continue to limit the upward mobility of associates. The issues this raises regarding career planning, performance management and talent retention are significant. The changes in the shape of law firms and equity partner numbers will be evolutionary and most likely a lengthy process. Current signs are difficult to interpret because of the rapidly changing shape of the top end of the market. However, as an indication of the emerging trend, of the top 50 law firms surveyed by Legal Week, 14 have seen a reduction in the past year in equity partner numbers.

Diminishing associates

According to recent research by ALM Legal Intelligence, since 2008, the number of associates in the 250 largest law firms has diminished by more than 7,000.

8. Legal structure of law firms and the emerging models

There are several different operating models that law firms can choose from if they wish to expand, grow their market share, and increase their areas of practice and expertise, both at home and overseas.

The traditional general partnership has given way almost entirely to the limited liability partnership (LLP). As a result of the December 2013 Finance Bill, the LLP structure will likely be subject to significant fiscal stress as a result of which it will decrease in popularity as the legal structure of choice for the legal profession. We are increasingly likely to see the emergence of the limited company featuring as the preferred law firm legal model.

Already there has been a spate of high-profile cross-border mergers in the legal sector, as well as a renewed interest to form strategic alliances and partnerships with other firms. Many firms have pursued their international growth strategy utilising the well established and flexible Swiss Verein legal structure.

While these arrangements may give law firms greater access to new markets, boost areas of expertise, and in time produce greater economies of scale and efficiencies, what are the benefits to clients?

So far, it is difficult to judge. Clients are not fixated by the type of business structure a law firm utilises: clients with international needs simply want consistency of service and expertise; agreed pricing; more accountability and control of how they are engaging the service; and transparency about the level of partner involvement. If a firm is unable to respond to these competitive forces and meet these requirements, clients will simply drift to other firms who can respond with greater clarity on these issues. As discussed earlier, there is an abundant supply of law firms for most instructions and no scarcity of international firms. Therefore, firms need to ensure that any business structure they adopt does not impact negatively on service delivery, and indeed positively supports business development, positive co-operation and first-class execution by the firm.

Overseas expansion also does not guarantee that clients will use a firm's services in a foreign jurisdiction. Clients with international operations may initially feel more comfortable to use their existing historical law firms that have expanding international offices with a presence in those particular markets. But loyalty is not guaranteed if the level of service or expertise is not matched from one location to the other. Uniformity of high-quality service and delivery are paramount and fundamental to success.

There are other significant problems. Full equity mergers are complex and take time to integrate, and referral networks are only as good as the partner firm that law firms are recommending. Swiss Vereins, on the other hand, are relatively quicker to build and offer more flexibility. They are essentially separate firms operating under an 'umbrella' all-encompassing brand: they do not necessarily guarantee unified levels of expertise or service from one office to another. Levels of integration, co-operation, sharing of clients and working successfully on multijurisdictional matters may vary enormously. The resulting management challenges therefore cannot be underestimated and are significant. However, the power of the end product, if well executed, surpasses the deliverables of the component parts.

Consequently, unless law firms that have merged or formed alliances can offer the same levels of service consistently across all locations, clients will consider using other firms to suit local needs. This may mean smaller, independent firms could benefit from any perceived failings in their larger rivals – bigger may not mean best. The international legal landscape has become crowded very quickly. While very relevant to many clients with international operations, and therefore important in responding to client needs and building revenues and market share, an international network of offices of itself, can no longer be considered a point of differentiation and a source of competitive advantage.

"Clients with international needs simply want consistency of service and expertise; agreed pricing; more accountability and control of how they are engaging the service; and transparency about the level of partner involvement.

9. Law firm clients and buying behaviour

The UK market for legal services is currently a buyers' market, which means that clients are in a position to more readily dictate terms on price, service and ancillary support.

The pressure on billing rates is set to continue, as is an increasing requirement for alternative fee arrangements, greater pricing transparency and more value. For some years, clients have objected to the standard way that law firms have charged for their services – the use of flexible rates and billable hours – and have pressured firms to adopt fixed fees, as well as demand inclusive add-on services such as the provision of secondees.

Clients are trying to reduce their legal spend, and historically one way of achieving this has been to set up legal panels. These enable companies to have a consolidated group of law firms available to handle all aspects of commercial law work, while having greater visibility of what each law firm is doing and better control of costs. Some multinational companies, for example, had been using over 100 law firms around the world during the same period, and have managed to dramatically reduce this to fewer than 20 worldwide, thereby vastly reducing their legal spend while offering panel firms a greater share of their legal work.

Consequently, as clients continue to take more control over their legal spend, law firms will increasingly pursue opportunities to be appointed as panel firms in an effort to foster deeper, long-term client relationships.

In October 2013, supermarket chain Morrisons unveiled its first-ever formal legal panel, while Wales's largest social landlord RCT Homes has awarded 13 firms a place on its first-ever legal panel. Previously, 80% of RCT Home's legal spend was with just one firm. With the introduction of a formal panel, the process is expected to save the housing trust between 20% and 45% on legal spend.

Major law firms are also being lured by international panels. Firms including Baker & McKenzie, Herbert Smith Freehills and Hogan Lovells have won spots on Chinese state-owned conglomerate China Resources' first international legal panel. The Hong Kong-headquartered company invited law firms to tender for places on its panel at the end of 2012 in a move to formalise the selection of external counsel and control the quality of legal advice.

Legal panels, already popular, are set to become the norm for the many advantages they deliver clients: the prime one being that they afford the customer more control. For example, informed general counsels can unbundle and disaggregate instructions and customise the legal work to suit their needs, while also splitting the work between several firms according to their competencies in conducting different types of legal work more effectively and efficiently.

In the future, firms can therefore expect a greater discussion about costs, and they will need to prepare themselves to collaborate and work with other firms to be awarded instructions and develop the client relationship.

However, while clients are set to take more control of the relationship, proactive law firms can leverage their position within the panel to deliver other services. Other professions – such as accountants and IT contractors – have successfully cross-sold services into clients through an initial 'loss leader' engagement. Conflicts of interest notwithstanding, it is clear that some law firms are following in their footsteps. While this is a valid strategy and is visible both in the UK and internationally, it is not sustainable in the long term. The erosion of margin and dilution to profitability will be quickly evident if not mitigated by the delivery of high-value and profitable work. General counsel will also need to play a long-term relationship game so as to provide core panel firms with meaningful and profitable long-term relationships.

"The pressure on billing rates is set to continue, as is an increasing requirement for alternative fee arrangements, greater pricing transparency and more value.

Legal panels

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10. Disaggregation of legal instructions

The overwhelming majority view of the legal services market is that clients want more value from law firms, as well as greater visibility and a discernible break-down of the composition of charges.

Clients are consistently pushing for more predictability and transparency around costs, and an end of the billable hour. The fact that buyers are driving the market means that law firms need to concentrate on costs and process. Clients are less tolerant of accepting a firm's fees if the majority of the work they require can be done by an associate or paralegal, rather than a higher-cost equity partner.

Simply, clients want to know the lowest level of competence at which legal work can be done, and are increasingly demanding their legal advisers deliver legal services on these terms. The healthy supply of lawyers and law firms in the market firmly places the balance of power in this negotiation with the clients. They are no longer prepared to support an industry which needs to reengineer its business model and reduce its capacity. Of the various tools available, price is the key variable which clients are asking firms to flex, combined with the seniority and type of resources allocated to the work. To the latter point, the UK legal services market continues to be over-lawyered. This is evident by survey results referred to earlier, together with the RBS survey and research produced last year, which concluded that UK commercial firms were over-lawyered by up to 5%. There is also evidence that companies with legal capacity will simply take the work back in-house if law firms cannot do it more efficiently and cost effectively.

The UK legal sector is ideally placed to seize the opportunity to again lead the global market and establish practices which other legal markets around the world will follow.
The pressure on fees is forcing law firms to consider the benefits – and needs – of disaggregation very seriously.
Disaggregating legal services allows firms to critically examine how they carry out a piece of work and assess whether parts of it can be can be carried out at a lower cost, more quickly and even to a higher quality by junior lawyers or other providers. This inherently offers the promise of greater efficiency, and protects and possibly enhances margins and client relationships. It also allows key fee earners – namely partners – to focus on more demanding and technical work for which they can be better rewarded, and should therefore be more profitable.

Secondly, disaggregation offers a new way of differentiating the firm and its services.
It shows clients that service processes have been isolated and, through this effort, improved over existing or alternative processes.
The demonstrable result will be reducing costs and turnaround times while maintaining or improving quality.

Over-Lawyered firms

UK commercial firms were over-lawyered by up to 5%.

By breaking down the legal process and examining its component parts, law firms can see more clearly how existing staff can be used across the business.

Several leading commercial firms have repositioned commodity, repetitive and low-value work. In April 2011, Herbert Smith Freehills opened a Belfast office, specialising in document management and review, principally for major contentious cases. Allen & Overy opened its support services centre in Belfast in July 2011.

Disaggregating aspects of work also allows firms to plan ahead more efficiently and to use headcount more effectively. As described previously, importantly it delivers flexibility into the law firm model and starts to build variable costs into the law firm cost structure. Many law firms have taken on new hires when areas of practice are booming, only to find that they face expensive staffing costs when demand for such services declines, or that staff numbers have to be cut. By breaking down the legal process and examining its component parts, law firms can see more clearly how existing staff can be used across the business, rather than have to buy in resource and let it go shortly after.

It also enables firms to use contract lawyers and paralegals, delivering the advantages of flexible working arrangements to those professionals, while providing talented and capable resources to firms when required, and superior value and efficiency to law firm clients. An early mover in establishing a contract legal service was Berwin Leighton Paisner with its Lawyer on Demand business. A very new entrant into this market is Allen & Overy with its November 2013 launch of Peerpoint. This will deliver a panel of lawyers to work flexibly for Allen & Overy on a contract basis and as this business matures and builds scale it will also offer clients access to these lawyers.

It is estimated that only around 5% of a lawyer's total workload is exclusively dependent on having a legal qualification – the rest (mainly administrative work) can be done by more junior staff. Therefore, if partners can identify which parts of their work they can pass on to non-qualified staff, they can deliver the resulting financial benefits to clients. Partner time can then be used to focus on more value-adding tasks which will drive revenues higher through delivery of more high-value advice.

Presently, the majority of firms – particularly large – are reviewing, but not overwhelmingly implementing, disaggregation strategies. But this will need to change – and will be forced upon firms by clients if the firms do not proactively adopt this principle. Clients will not tolerate unnecessarily paying inflated fees for services, or simply accept that costs are high because legal services are delivered through inefficient business models.

Dependency on a legal qualification

5%

It is estimated that only around 5% of a lawyer's total workload is exclusively dependent on having a legal qualification

11. Resourcing alternatives – LPO and on-/off-shoring opportunities

Without doubt, legal process outsourcing (LPO) and other non-legal business processes delivered through a variety of structures such as on-shoring and off-shoring are set to continue to grow over the next few years.

In our survey, 100% of respondents said that they expected the level of their firm's utilisation of LPO services to either stay the same or increase within the next 12 months, while 97% said that the level of back-office outsourcing would stay the same or increase.

In 2007, Clifford Chance launched a low-cost base, called The Knowledge Centre, in New Delhi, India. The magic circle firm became the first major firm to set up its own 'offshore captive' legal process outsourcing operation. In the 2012 annual review, the firm revealed that The Knowledge Centre provided support work to its legal teams in 27 offices outside India and supported on a total of 850 matters providing almost 50,000 hours of support to London, Singapore, Paris, New York, Amsterdam, Washington, Hong Kong, Milan, Dubai, Madrid and Abu Dhabi.

Addleshaws Goddards' transactional services team (TST) was launched in Manchester in 2010 to handle e-disclosure, due diligence, document management and review. Originally staffed by a handful of paralegals, it now has a headcount of around 100. With the typical regional paralegal salaries well below London qualified solicitors, the initiative has yielded significant savings and is a model that other law firms are surely set to follow.

There are two key drivers: due to the intensely competitive environment and pressure on fees, to remain competitive law firms need to cut costs by delivering work through lower-cost providers, and – equally important – clients are increasingly demanding that firms work with LPO providers as a condition of engagement.

There has been a change in the legal business culture over the past few years, with increased focus on unbundling legal services in order to benefit from economies of scale. Whereas previously LPO was treated like other back-office support functions, firms and legal departments have become more open about using LPO, to the extent that some clients request or require its use to minimise the cost of routine legal work. For example, Ashurst has recently opened a 150-strong legal service support centre in Glasgow while trimming numbers in London in response to client requests that it use more outsourcing to cut costs and improve efficiency.

Utilisation of LPO services

100%

of respondents said that they expected the level of their firm's utilisation of LPO services to either stay the same or increase within the next 12 months.

97%

said that the level of back-office outsourcing would stay the same or increase.

Fifteen of the top 30 law firms by revenue either have a formal arrangement with an LPO supplier or have set up their own dedicated service centres. Herbert Smith Freehills has its centre in Belfast to handle back-office and support work, while Mills & Reeve has opened a low-cost paralegal unit in Norwich. CMS Cameron McKenna has dedicated LPO operations in Bristol, and Addleshaw Goddard uses its service centre in Manchester. Many other firms are currently reviewing their options.

It is expected that the LPO market will continue to show strong growth. According to recent research conducted by the London School of Economics (LSE), the LPO industry is currently worth US$2.4 billion worldwide. Furthermore, the LSE believes that industry players are set to expand into higher-value, more complex work.

The research, conducted in association with Orbys, an outsourcing adviser, also predicted that the relationship between the legal function and the LPO provider will change and will be based on "new engagement models"; instead of firms or in-house legal functions buying specific and individual services, they will engage with an LPO on an overarching managed-service model.

But a key problem that law firms face with relying on LPOs is ensuring quality of service. While clients will inevitably welcome a reduction in charges, in-house counsel want assurances that the relationship will not result in any deterioration in the service offering. They also want guarantees that their data is secure and protected, and that the law firm is liable for any failings in these regards under its professional indemnity cover.

Therefore, while LPO is set to grow, law firms will need to ensure that they properly manage the relationship: clients expect the work to be carried out to the same standards by the law firm outsourcer, and general counsel will hold firms directly responsible for anything less.

It is expected that the LPO market will continue to show strong growth. According to recent research conducted by the London School of Economics (LSE), the LPO industry is currently worth US$2.4 billion worldwide.

12. Alternative business structures

While alternative business structures (ABS) have only been active in the legal services market for the past couple of years, there are already some indicators that high-street solicitors' practices and small law firms are beginning to feel their impact.

According to research by the Association of Business Recovery Professionals (better known as 'R3'), competition from ABS has increased pressure on law firms to the point that 2,556 (31% of all law firms) are at risk of financial failure in the coming year, with the situation worst in London, and best in Wales and Yorkshire.

The news comes at a time when the Solicitors Regulation Authority has highlighted financial instability as the main current threat to the profession.

Part of the reason why smaller firms are under threat is that they are unable to afford the level of branding, marketing or technology to compete with ABS funded by some heavyweight corporate names.

For example, Admiral Law, BT Law, Co-op Legal Services, and Irwin Mitchell are already leveraging their corporate reputations to secure business in the high-volume transactional aspects of legal services, such as wills, probate, conveyancing, property valuations, employment law and personal injury.

And more are looking to follow suit. In July 2013, Britain's biggest car insurer, Direct Line Group, applied to the SRA to become an ABS. The insurer wants to create a newly formed and wholly owned law firm, DLG Legal Services, to operate in partnership with existing law firm Parabis.

Accounting and professional services firm KPMG is also looking to recruit a team of corporate lawyers in Manchester as it weighs up an ABS conversion as part of a push to expand its legal services offering. Their peers will surely follow. This development is particularly important, given that the Big Four accountancy firms have had a highly successful track record of moving away from accountancy and audit into complementary advisory and consultancy businesses to satisfy client needs while boosting their own revenues – and they will surely look to compete in the large corporate market.

Yet so far, the threat from ABS seems contained to the lower-end or high volume sectors of the legal services market: they are focusing on high volume, process-driven legal work, while also fulfilling the aims of the Government and the Legal Services Board that access to justice is being maintained. Indeed, the fact that only one respondent in our survey cited the impact of ABS' as an area of focus for his/her law firm indicates that large firms do not perceive these new entrants as a threat – at least not yet.

However, ABS are not limited in the services that they can offer to the public. Consequently, while these new entrants may presently be happy to 'test the water' providing relatively simple legal services at the lower end of the market, they can expand their service offering and tap into other profitable areas should they wish to in future. This seems a logical evolution, and certain participants in the ABS market have aspirations to build into the mid-tier market where they can service larger clients.

ABS have the advantage of relying on lower-salaried lawyers, paralegals and support staff which may enable them to be more agile in a competitive market. And given that such big brand names as BT and KPMG are moving into the sector, they have the expertise and resources to offer more specialised services, and will ultimately encroach on the work done by bigger firms.

Financial failure

The Association of Business Professionals (R3) say that

31%

of all law firms are at risk of financial failure in the coming year, with the situation worst in London, and best in Wales and Yorkshire.

13. Technology

The legal services sector regards IT as an invaluable tool to win business. In the recent RBS survey, over 82% of respondents said that they regard IT as a source of competitive advantage, and half (50%) said that they are planning for a major technology upgrade in 2014.

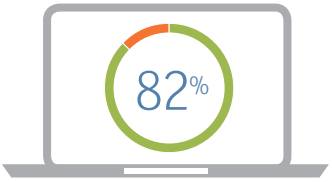
Law firm IT spend is typically centred on the day-to-day internal requirements of the firm, such as software for case, knowledge and practice management, and billing and time recording. Over the past few years, firms have embarked on roll-outs of such technology upgrades across their operations in the UK and worldwide, with several firms still planning to make such investments. However, firms are also beginning to invest in more cutting-edge technologies, such as those that help speed up e-disclosure.

The impetus behind this is two-fold: clients are pushing for more predictability on costs, such as opting for a flat-rate rather than the billable hour, which means that firms need to have better control of their own expenditures and costs; and pressure from senior judges who want law firms to have systems in place to file, record and retrieve information quickly and cost-effectively, as well as have transparent procedures in place to justify costs.

But while firms are prepared to invest in technology to support the business, they need to have a clear strategy about what they want to achieve as a result – since the benefits can take years to materialise. Although upgrading IT systems will help reduce costs and speed up processes in the long term, the potential benefits could be diluted if the firm's underlying business model leaves profit margins at their current low levels. Also, a full roll-out of new systems or software can be an expensive and time-consuming process, particularly if a firm expects to perform an upgrade simultaneously across all offices.

Technology

Is IT a source of competitive advantage?



Key

- Yes
- No

14. SRA and the role of the regulator

Since October 2011, when the Solicitors Regulation Authority (SRA) introduced its outcomes-focused regulation, the nature of industry oversight has changed.

The SRA has become more concerned with how firms consider risk management and corporate governance. Within the scope of this – given the economic climate – how firms manage their finances. Furthermore, the regulator is considering whether it needs further powers to deal with financial instability in law firms.

In June 2013 the SRA warned law firms of the "temptation of straying from the compliance path" as the tough economic climate continues.

As part of its investigatory work, the regulator has found evidence that financially unstable law firms are misleading funders, inflating work-in-progress valuations, and producing shortages in client accounts. More generally, key features of those firms that have so far failed include sheer naïvety, an over-dominant partner, and the lack of a good finance director.

The ability to demonstrate effective corporate governance is going to become a key concern for law firms, and this is going to require a serious time and management commitment from partners to ensure that appropriate risk reporting and financial controls are in place. Partners should also be aware that they still have ultimate responsibility for corporate governance issues, even though the firm will have a compliance officer for legal practice (COLP) and a compliance officer for finance and administration (COFA) in place.

The SRA has also demonstrated that it is willing to take a more 'hands on' approach after it announced that more than 30 of the top 200 UK firms are in "serious financial difficulty", and that it was in "intense engagement" with 160 firms at risk of failure, of which eight were in immediate danger and one-fifth were deemed "high-impact".

Half-way through 2013, the SRA said it had identified around 2,000 firms – one in six – it believes are "particularly susceptible to financial difficulty" due to, among other issues, an "over-reliance on a particular type of work". The weight of this 'financial difficulty' is heavily borne by the lower end of the market.

Key features of those firms that have so far failed include sheer naïvety, an over-dominant partner, and the lack of a good finance director.

The SRA has started to evaluate firms' financial data to see how well managed they are. The regulator is examining net profit, total borrowings, and highest and lowest bank balances over quarterly periods. The initial focus is on firms working in areas that are experiencing particular economic pressures, such as personal injury or legal aid, as well as around 500 'high impact' firms that would have a significant impact on the regulatory objectives if they were to fail.

The SRA has also shown a willingness to become more interventionist. The 2013 year saw a substantial rise in the number of interventions on 2012, and the regulator has indicated that it could intervene in a similar number of firms year on year. The SRA is particularly concerned that large and well-established firms could feature among the casualties. This year, Cobbetts, Blakemores and Atteys are three of the more high-profile failures.

Law firms should be aware that the regulator intends to get more actively involved in monitoring the sector's financial management. Furthermore, given the SRA's pronouncements about the state of even the industry's biggest players, it is not shy to go public with its concerns. While 'naming and shaming' is not part of the SRA's approach, clients may make associations about the financial state of firms that may not be accurate and which could be difficult to assuage.

The problem of having an intrusive and pro active regulator is not going to go away – in fact, the SRA's approach is more likely to intensify. Senior managers of law firms will need to allow more time to work on compliance, financial management and corporate governance issues, and this is likely to be a drain on management time and lead to an increase in costs. Unfortunately, this all comes at a time when margins are already under severe pressure. Furthermore, those firms at the lower end of the market are going to feel the strain more than others, and in most cases have less financial resources and human capital to focus on the issues.

15. Professional indemnity insurance

Professional indemnity insurance (PII) is a major law firm expense – irrespective of the size of the practice – and changes that came into force in October 2013 saw the cost of policies go up for many firms.

The majority view from market participants is that smaller firms – particularly those with five or less partners – are finding it hard to get premiums in line with previous quotes, due to the fact that these firms are responsible for the highest volume of negligence claims and are less likely to have thorough risk management processes in place. XL – which had the largest share of the market – announced in August 2013 that it would no longer underwrite for firms with one to three partners.

Instead, smaller firms will increasingly need to take their chances with unrated insurers, and recent experiences do not inspire confidence. The collapse, in June 2013, of Latvian unrated insurer Balva, which provided cover for around 1,300 law firms (or 7% of the market), is just the latest in a line of high-profile exits. In 2010, Quinn Insurance exited the PII market, forcing thousands of UK firms to look for new insurers. Ukrainian firm Lemma Europe Insurance Company (which only entered the UK PII legal market in 2009) was forced into administration in October 2012, and household insurer Aviva was forced to quit its £30 million-£35 million premium market share citing "a sustained lack of profitability over several years".

Another blow is that from 1 October 2013, the assigned risks pool (ARP) – a kind of insurer of last resort – was scrapped. At the time of writing, a total of 185 law firms have applied to the Solicitors Regulation Authority (SRA) for the 90-day extended indemnity period (EIP) of insurance having failed to secure cover by the deadline date.

At the higher end of the market, the UK's top law firms are unlikely to experience much difficulty in securing their primary cover from a rated insurer, and buying excess layers is unlikely to be an issue. Current rates for large firms are broadly in line with what they have been for the past couple of years. But the market is not very competitive. Presently, there are only a handful of insurers who are capable of providing the kind of primary coverage that top law firms need – which means that many firms are reluctant to change their primary insurers. As a result, the withdrawal of capacity has made the market riskier for firms in terms of their bargaining power to get better terms and coverage.

However, fewer insurers want to enter the market, and even those insurers that dominate such as Hanover, Allianz Global Corporate Specialty, and XL who all joined in 2009 and account for one-third of the total premium income – have said that they are not keen to underwrite more premium.

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Withdrawal of capacity has made the market riskier for firms in terms of their bargaining power to get better terms and coverage.

One reason may be that while the 'tsunami' in historical negligence claims arising from professional advice given in the run-up to the financial crisis has not really occurred, insurers may still be wary of entering the PII market for at least another year until the six-year claims limitation period officially ends, as some believe that there could be a last-minute rush to process claims arising from property valuations.

Another reason is that insurers complain that the sector is not particularly profitable given the 'restrictions' associated with the SRA's minimum terms and conditions that participating insurers need to follow. As a result, some have said that they are not predominantly interested in attracting many more clients or achieving much more gross written premium over the next year or so. For example, Allianz Global Corporate Specialty has said that it does not envisage adding to the number of firms that it writes for, saying that the legal PII market is not as profitable as other areas of PII.

However, across the board, law firms have noticed that insurers are now asking more questions about the financial position of law firms. Historically, insurers were largely content to require information about turnover, but now it is increasingly common for them to request the annual accounts, as well as the management accounts for the months since the year-end up until August. Given the SRA's recent pronouncements about the poor financial management of many firms – including some in the top flight – this is not surprising.

There are some other changes that are noteworthy and perhaps tip the odds in favour of law firms. October 2013 saw the end of the single renewal date, which means that law firms will be able to purchase PI insurance when it best suits them, and can potentially negotiate longer – and more attractive – terms.

Some insurers – such as Travelers – had already been testing the water by sending clients 'early bird' offers of 17-months cover. Zurich has also welcomed the change to flexible renewal dates enabling firms to choose a date that best suits their business.

The prognosis for the future is that large law firms are likely to continue to find suitable primary PII cover, but premiums will depend on the level of financial and risk management information they can provide to their insurers. Smaller law firms will continue to struggle as insurers retract from writing premiums, and unrated insurers may be the only players that want to actually enter the market.

16. Conclusion

The legal profession and the business of law will never be the same again. This should not be viewed as a cause for concern, but rather a recognition that the legal market is presently moving more quickly than ever in its history. It represents a wonderful opportunity for the legal profession to prosper and excel both in the UK and globally.

In order to be successful, market participants will need to move quickly to keep abreast of the changes reshaping law firm structure and the method of delivery of legal services. Firms that are nimble, agile and responsive to client needs will fare better than those who are slow or have difficulty in adapting. In the final analysis, segmentation of the legal market according to financial measures of success will provide the score-card measuring how well firms have responded to these changing conditions. And unfortunately, there will be casualties along the way.

However, I am convinced that the UK legal profession will continue to lead the world for its innovation and creativity, thereby retaining a preeminent position as a leader in the global market for legal services.