2017 Legal Benchmarking Report

NatWest

Contents

Foreword

Welcome to our fifth edition of NatWest annual legal benchmarking report which focuses on firms operating at the SME level across Wales, England and Scotland. Working alongside Robert Mowbray, our findings provide highly valued insight comparing the financial performance of local and national peers. In many cases the report has helped promote further business focus and process to drive improved performance.

This year's report consolidates the financial performance of 269 legal firms covering the financial year end 2016 and also reviews the actual performance predicted by firms in late 2015.

Economically, 2015 and the majority of 2016 were positive years with high levels of consumer and business confidence, certainly pre-Brexit. The financial performance of SME sized legal firms is usually closely aligned to that of the economy and as such average revenue growth of 5% is not a surprise. The combined average growth rate over the last two years at 11% is very positive when compared to many other industries.

Revenue growth by volume has facilitated an improvement in profit for the owners of legal firms and in 2016 the average profit per equity partner (PEP) was £120,000. Year on year, PEP has improved and the 2016 performance is 33% up from 2013.

So once again the business climate for legal firms has been positive and generally firms are in good financial shape.

The findings of this report are based on historic financial data and therefore give a rear-view perspective on the sector which may not be entirely relevant moving forward given the potential headwinds predicted for the domestic and global economy in 2017 and beyond. Indeed, the Law Consultancy Network half year survey recently identified that the top three issues for legal firms in 2017 would be cashflow, Brexit / global political uncertainty and improving profitability.

This report highlights some obvious areas of focus and opportunity for legal firms if revenue growth does not continue at the pace witnessed in recent years. Efficiency has to be an area worthy of more attention. Much of the recent revenue improvement has been accommodated by an increased workforce as can be seen through the increased gearing number but in turn this has reduced fee earner efficiency with the majority generating just 3.9 hours of daily billable time with the actual net profit (before drawings) position reducing back to 23%.

It's always wiser for firms to focus on their cash position but in recent months this has become even more prevalent. If we are entering a period where the economic waters will get a little choppy then it is those firms that manage their cash who will be best placed to sail through the storm.

Firms should look to reduce their lock-up which at an average of 113 days is now longer than at any time in the last 5 years. Without a constant flow of new matter starts and paid fees they would, on average, run out of cash within 40 days, possibly something worth thinking about before all the cash is distributed in the form of partner's profits.

A further area of risk for legal firms comes in the form of cyber attacks. Our findings suggest that one in four of all legal firms have been the subject of a criminal attack and some of them would have incurred a financial loss and potentially reputational damage. There is huge pressure on firms to be ever more diligent and to ensure that they have a disaster recovery plan in place.

As we look to maximise Robert Mowbray's practical experience and wealth of knowledge, we have included a new section "Improving productivity – the best way to improve profitability". It provides a simple diagnostic tool to enable you to identify what areas of performance improvement will have the greatest impact.

NatWest remains committed to supporting legal firms in developing a successful and sustainable business. Our specialist relationship directors understand the professional services sector and benefit from accredited training and regular sector updates. If you would like to speak to one of our team or attend our annual legal conference, please get in touch.

Finally, I would like to thank Robert Mowbray for once again sharing his sector knowledge and experience in the production of this report and its continued development over the last five years.

Steve Arundale
Head of Commercial Professional Sectors, NatWest

Executive summary

This survey is a substantial review of law firms with fee income of up to £123m. 269 firms employing 16,000 people took part in the survey from across England, Wales and Scotland. The total income of the firms in the survey was £1.42bn.

Some of the more interesting findings of the survey were:

Profits

- The median profit per equity partner (PEP) is £120,000 which is £9,000 higher than the figure reported in the survey last year.
- The median profit per equity partner in small firms of £75,000 is less than half of the median figure in large firms being £164,000.
- The median profit margin dropped to 23% which shows that the growth in profit per equity partner is coming from an increase in volume which has more than offset the drop in efficiency. Firms need to focus more on delivering better margins.
- The increase in profits has been driven primarily by a significant increase in gearing from 3.20 to 3.94. However, recorded chargeable hours per fee earner are down as is the recovered rate per hour which shows that firms need to focus more on time recording and pricing and fee negotiation. If firms could focus more on profitability, and perform at the upper quartile point for gearing, recorded hours, recovered rate and margin they would achieve a PEP figure of £482,000.
- Only 1% of delegates attending the autumn 2015 NatWest conferences predicted this fall in recorded hours and only 8% predicted the fall in recovered rate per hour. The vast majority of delegates assumed everything would continue to improve.

Fees

- Median fees per fee earner were £136,000 which was down from £144,000 in the previous year and demonstrates a significant drop in productivity.
- The median fees per equity partner is £539,000 with the lower quartile point being £340,000 and the upper quartile point being at £858,000. This is a significant increase on last year.
- Fees have grown by 5% compared with a 6% increase last year which is still considerably above inflation. There is some regional variation with the South East achieving 9% growth while the North East & North West declined by 1%.

Lock-up

- Median lock-up is 113 days being 4 days more than last year. The upper quartile point is 73 days and the lower quartile point is double at 154 days.
- As firms get larger they find it increasingly difficult to manage lock-up. Median lock-up for small firms is 84 days, for large firms it is 131 days and for very large firms 142 days.

Finance

- Law firms remain cautious about carrying debt and the median bank balance was £94,000.
- The spare capacity in the overdraft has a median figure of 11% of annual fees with little variance in this number for different sizes of firm. This suggests that the median firm would run out of money in about 40 days if they received no further money from clients in that period.
- Client money balances are typically 129% of annual billings. The firms in the survey are holding about £2.3bn in client deposits. It is clearly important that firms do everything possible to ensure that these funds are kept secure and that there is a focus on cyber security.
- 24% of firms have experienced a fraud related loss or cyber-attack in the last year.

About the author

Robert Mowbray is a Chartered Accountant, trainer and consultant who has worked in and for professional firms for over 30 years.

His involvement with law firms began in the late 1980s and quickly developed into a niche business. His book entitled "Maximising the profitability of law firms", published in the mid-1990s, was the first book on law firm financials. He has been involved in a large number of surveys in the legal profession which have focused on the financial health of firms but he has also worked on other surveys to research other aspects of law firm performance. He is the author of "Law firm finance & administration handbook – a practical guide for COFAs and finance professionals" which was the first book to be published on the role of the COFA.

Robert works each year with about 80 firms and helps them with anything to do with improving their financial performance. He has assisted in many areas, including improving the quantity and quality of time capture, improving the ability of fee earners to negotiate fees with clients and to introduce more creative fee arrangements, managing lock-up to improve cash flow, profit sharing arrangements which reward improved business performance and strategic and business planning.

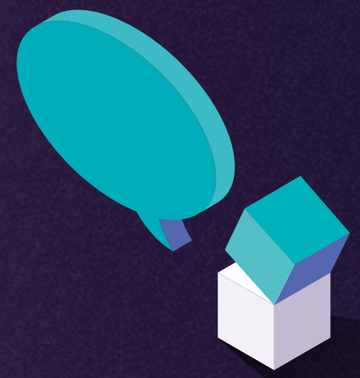
He has worked with law firms in over 40 countries and has worked with close to 1,000 firms in total. His clients range from the global elite, through major regional firms and to a large number of small firms and sole practitioners. He is an owner of Taylor Mowbray LLP. This is a niche business which focuses exclusively on law firms which he runs with Janet Taylor, who is an authority on the SRA Accounts Rules.

TAYLOR MOWBRAY LLP

If you have further questions for Robert, please feel free to contact him via **www.taylormowbray.com**

A few focused improvements can quickly lead to a significant improvement in performance and cash flow. Comparing your existing performance against that of peer group firms is a good way to determine where your opportunities lie.

Introduction



2016 was a year that taught us that we can never predict the future with any certainty. In the summer of 2015 you could have obtained odds of 5,000-1 on a treble bet of Leicester City winning the Premier League, a Brexit vote and Donald Trump becoming President of the USA. The danger remains that law firms anticipate another year like the last and, as a result, become complacent. At the autumn 2015 NatWest conferences delegates were asked to predict what they thought would happen in 2016. When you read the survey you will see that very few people predicted what has actually happened.

More firms have failed this year and have gone into administration and the same will presumably happen to other firms next year but nobody ever thinks that it will be their firm. The Brexit vote on 23rd June 2016 has created huge uncertainty in the economy and this is bound to have an impact on the legal sector. Most firms have not yet worked out whether the changes that are fast arising will be good or bad for them. The first half of the 2016/2017 financial year saw significant double digit fee growth in many of the larger international firms. While at first sight this might suggest significant growth, the reality for many such firms was that the growth was primarily driven by the fall in the pound with the effect that fees raised abroad now have a higher Sterling value.

Other significant changes are influencing the market in which law firms operate. The rise of Artificial Intelligence is bound to have an impact on what lawyers do and can charge for in the future. Staff are demanding a more agile way of working and the cost of regulation shows no sign of falling. Clients continue to demand lower fees and more certainty around fees. Organised crime gangs are increasing their efforts to help themselves to client money and firms therefore need to be very vigilant and ensure that they have appropriate insurance in place. It remains as important as ever to understand exactly how your firm is performing in a very competitive market.

A few focused improvements can quickly lead to a significant improvement in performance and cash flow. Comparing your existing performance against that of peer group firms is a good way to determine where your opportunities lie.

This is the fifth year of the survey and we were keen to continue with some of the reporting which has made the survey so popular while adding in some new elements to give readers something extra to consider. The report is based on contributions from 269 firms using figures from their financial year ending in 2016. The combined fee income of the firms in the survey is £1.42bn. The combined profits were £365m and cover 1,877 equity partners. The information is broken down into a number of regions as there is a significant difference in the performance of law firms across the UK. The report also analyses the performance of firms of different size to see if there is an optimum size of firm. At the end of each chapter we have also provided the longer term trends over the last five years.

The report provides median, lower quartile (LQ) and upper quartile (UQ) figures. Firms want to be the best at everything but this is clearly unrealistic. Firms tend to talk about what they are good at and try to get even better at this rather than focusing on areas of under-performance where improvements might more easily be achieved. When looking at the tables, it is perhaps best to focus on the areas where your firm is currently below the upper quartile figure and to think about what needs to be done to generate better results.

Table 1 shows an analysis of the firms in the survey by region and by size. Three regions were grouped together to form Wales, Midlands and East of England as there were not enough firms for these regions to be analysed separately. The survey has divided the firms into two sizes of firm. Those with annual fees of less than £2.25m are described as "small" while those with fees in excess of £2.25m are classified as "large". The tables contain an extra line of data for the "very large" firms being firms with annual fees in excess of £5m. These firms have then been subdivided into "small" (annual fees between £5m and £10m) and "large" being firms with fees in excess of £10m. The results for these very large firms have also been included in the figures for "large" firms, as was the case last year.

Table 2 shows the split of firms taking part in the survey by constitution. There are 109 LLPs compared to 91 partnerships. It is perhaps surprising that there are still so many partnerships given that virtually all new firms choose to establish themselves as either a company or an LLP. 41% of firms in the survey are LLPs while in the very large firms this increases to 68%. In two regions, Scotland and North East & North West, there are still more partnerships than LLPs but in most regions this is not the case and in London the number of LLPs outnumbers partnerships by well over two to one. There are definitely some firms that spend too much time worrying about whether they have got the right structure and not enough time on focusing on whether they are building a strong business. Having said that, firms should reflect periodically on what other firms are doing and whether they are operating with the right structure for their firm.

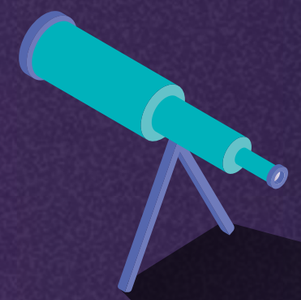
Table 1
Firms by location

	Small	Large	Total
London	13	31	44
South East	13	15	28
South West	12	18	30
Wales, Midlands, East of England	28	24	52
North East, North West	22	11	33
Scotland	54	28	82
Total	142	127	269
Very large firms	30	38	68

Table 2
Firms by constitution

	Partnership	LLP	Company	Sole practitioner	Total
London	8	21	12	3	44
South East	10	13	4	1	28
South West	10	14	6	0	30
Wales, Midlands, East of England	17	23	11	1	52
North East, North West	9	8	16	0	33
Scotland	37	30	13	2	82
Total	91	109	62	7	269
Very large firms	16	46	6	0	68

Legal Conference Series Survey
2017 Predictions

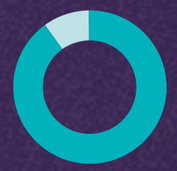


Participants

249 Total Contributions

73% with fee income > £1.5m

27% with fee income < £1.5m



90% have business plans in place

79% have a detailed time recording policy
89% of large firms
52% of small firms

Fees

63% believe that fee income will grow over the next year
That's down from 81% in 2015

64% of large firms

58% of small firms

think that fee income will grow

36% of large firms

25% of small firms

expect income to grow over 10% throughout the next year

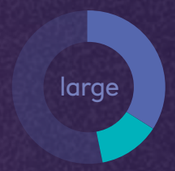
An increase on last year:
12% small firms, 24% large firms

Profits

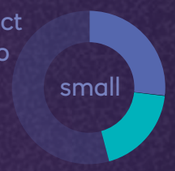
43% believe that margins will improve in 2017
2% less than previous year

Only 39% of all firms link their profit sharing to partner performance

47% of large firms expect profits per equity partners to increase
13% expect an increase of over 10%
Down 7% on last year



46% of small firms that expect profits per equity partners to increase
19% expect an increase of over 10%

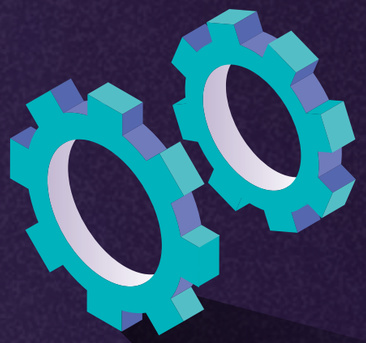


Finances

36% expect their bank balances to improve compared to 46% last year

11% expect their bank balances to fall

19% of firms expect their gearing to improve compared to 30% last year



Lock-up

Its believed that a reduction in debtor and WIP days would help improve cash flow

WIP Days	Debtor Days
22% think WIP days will be improved	**7%** think debtor days will be improved
Down from 35%	Down from 39%
That compares to WIP reduction at 43% in 2015 and 35% last year	That compares to debtor reduction at 44% in 2015 and 39% last year

8% of large firms expect to improve their debtor days (compared to 46% last year)

4% of small firms expect to improve their debtor days (compared to 27% last year)

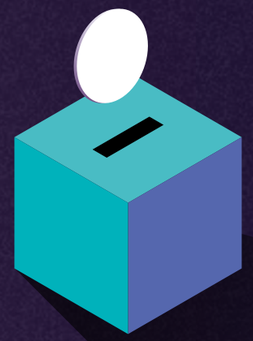
There has been a significant fall in the firms confidence to manage their lock-up, especially among the large firms

21% of large firms are expecting to reduce their WIP compared to 42% last year

24% of small firms are expecting to reduce their WIP compared to 26% last year

Source: Conference Series Survey Results – September 2016.

Fees



It is possible to make more profit without increasing fees by focusing on controlling and cutting expenditure. However, when the economy is growing, it should also be possible to make more money by growing fee income. It is clearly important that the growth is profitable growth and not arising from poor quality and unprofitable work. Profit is more important than growth and there are too many firms who make the mistake of thinking that if they grow they are bound to become more profitable.

One of the widely used measures of performance in legal businesses is fees per fee earner as it demonstrates the level of income being generated by each fee earner. This can then be compared to the salary cost of the fee earner to determine the multiple of salary costs which the fees generated represent. Good law firms have always talked about the need to achieve fees equal to three times salary costs when budgeting to achieve healthy profits. If this can be done and a further third is spent on overheads, then a healthy net profit of one third is earned for the equity partners.

If a multiple of three times salary cost is not achieved, then it will be difficult to achieve the same level of profits. Clearly, if productivity can be increased and the multiple is higher than three then it should be possible to make even higher levels of profit than have been achieved historically.

Table 3 shows the fees per fee earner being generated in the surveyed firms. The median figure overall is £136,000 which is an £8,000 or a 5.6% decrease on the £144,000 figure reported last year. This represents a surprising drop given that the fee income being generated by firms is rising. This would then suggest that perhaps firms are too quick to take on new staff rather than thinking about how the productivity of existing staff could be improved. It is no surprise to see that for small firms the median is lower at £124,000 while for large firms the figure is £147,000. In very large firms, the median is £144,000. The difference between being upper quartile across all firms at £179,000 and the £109,000 achieved at the lower quartile point equates to a 64% difference which is less than last year.

Table 3
Fees per fee earner (£)

	Small			Large			Total		
	LQ	Median	UQ	LQ	Median	UQ	LQ	Median	UQ
London	86	135	173	143	182	263	127	173	244
South East	106	117	144	140	169	205	113	144	184
South West	90	116	124	123	131	178	107	123	136
Wales, Midlands, East of England	92	105	145	113	144	183	101	127	160
North East, North West	83	108	125	111	147	170	88	111	139
Scotland	115	141	173	104	134	152	115	136	167
Total	99	124	158	121	147	187	109	136	179
Very large firms	126	144	169	124	177	214	124	144	199

Profit is more important than growth and there are too many firms who make the mistake of thinking that if they grow they are bound to become more profitable.

There are very significant regional differences once again. The overall median in London is £173,000 while the equivalent figure in the North East & North West is £111,000. It is important in all firms that there is constant measurement between the fees generated per fee earner with the salary cost of that fee earner. The danger is that as fees increase, the cost of the fee earners will grow at the same or an even faster rate and there will be no improvement in profitability.

Fees per equity partner is another useful measure. Combining the fees generated per fee earner with the number of fee earners working for each equity partner calculates the revenue generated by the equity partner and their team, as can be seen in the following formula:

Fees per equity partner = Fees per fee earner X Gearing

Table 4 shows the fees generated per equity partner and there is considerable variation across the regions and across the different sizes of firm. The median figure across all firms was £539,000 compared to the median in the survey last year of £480,000 which represents a 12% rise.

The median figure is £539,000 but the lower quartile figure is £340,000 and the upper quartile figure is £858,000. The upper quartile figure is therefore more than twice that achieved at the lower quartile point. It is important for firms to focus more on the billings of the partner and their team, rather than simply on the personal billings of the partner. If partners are too focused on achieving their own personal targets for billings, then not surprisingly the outcome might be that the team in total falls short of their target.

The London figures are consistently higher than for other regions. The upper quartile figure for large firms in London at over £1,437,000 should be noted as this is even higher than the upper quartile figures achieved for the very large firms. At the other end of the spectrum, the lower quartile figure in Scotland of £274,000 show that there is a very significant difference in this measure between the best and the worst firms.

The median figure of £539,000, which is up from £480,000 last year, implies that gearing averages 3.96 since, as has already been stated, the annual fees per fee earner are £136,000. The equivalent gearing figure in the survey last year was 3.33 so this shows a significant increase in gearing. Fees per equity partner have therefore increased because of an increase in lawyers and this has offset the reduction in productivity and the decline in fees per fee earner.

What has happened to total fees in firms since last year; has the growth that was seen last year been maintained? In the autumn of 2015 NatWest asked delegates at their conferences about their views on likely fee growth; 47% of delegates thought fees would rise by 0-10%. Given that the survey is comparing figures achieved in a year ending in 2016 with a year ending in 2015 it would be expected that growth would have continued as the economy grows.

Table 4
Fees/equity partner (£)

	Small			Large			Total		
	LQ	Median	UQ	LQ	Median	UQ	LQ	Median	UQ
London	346	631	749	606	1,161	1,867	578	884	1,437
South East	409	613	799	642	891	1,043	525	654	1,003
South West	283	368	509	678	765	937	460	678	866
Wales, Midlands, East of England	258	330	473	513	637	809	312	496	703
North East, North West	271	407	484	812	1,086	1,744	336	471	627
Scotland	230	307	633	413	475	780	274	412	646
Total	257	374	602	523	741	1080	340	539	858
Very large firms	539	843	1,114	585	887	1,417	563	873	1,255

Table 5 shows what has happened to fee growth and the overall median figure is growth of 5%, which is continuing to run at a higher rate than inflation, suggesting that real growth has been maintained.

While the overall median shows growth of 5%, the lower quartile position was a drop of 2% in fee income and the upper quartile position was growth of 13%. All of these figures show a small deterioration from last year The median for small firms was 2% growth, for large firms it was 6% and for very large firms it was 7% which demonstrates consistent growth across all sizes of firm.

Median growth rates of about 5% can be seen but it is interesting to see that this rises to 9% in the South East while in the North East & North West the median is a decline of 1% which does suggest a north south divide when looking at growth.

Historically, prior to the recent economic slowdown it was true in many legal businesses that the profit for the year was often fairly close to the bank interest earned figure. In other words, the law firm would cover its expenses with the fees earned and the profit would come from the premium interest earned on client account. The last few years have seen returning growth in transactional work which has resulted in law firms holding more client money. This however, coupled with the fall in interest rates has meant that the amount of interest being earned is still very low compared to the past. This has meant that most firms have had to look again at how they make money from legal services and to become less reliant on the interest earned on client account.

Table 6 shows just how little is being earned in interest with the median figure being 0.32% of fee income. Table 4 showed that fees per equity partner totalled £539,000 which suggests that the interest earned per partner at 0.32% of fee income would be £1,725 which would presumably be insufficient for most equity partners to live on. It is predicted that interest rates will start to rise again in 2017, although we have heard this before, and this should result in interest earned starting to rise again.

Table 5
Fees as a percentage of last year (%)

	Small			Large			Total		
	LQ	Median	UQ	LQ	Median	UQ	LQ	Median	UQ
London	93	102	116	100	108	122	98	106	118
South East	101	108	116	103	110	118	102	109	117
South West	98	104	107	102	105	113	101	105	111
Wales, Midlands, East of England	90	99	115	105	109	117	98	108	117
North East, North West	91	98	109	90	102	105	91	99	106
Scotland	94	102	112	102	104	108	98	103	110
Total	94	102	112	102	106	115	98	105	113
Very large firms	100	105	110	103	109	114	102	107	113

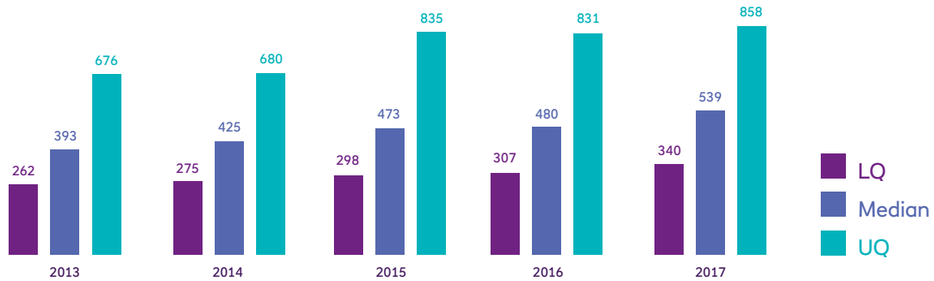
Table 6
Interest received as a percentage of fees (%)

	Small			Large			Total		
	LQ	Median	UQ	LQ	Median	UQ	LQ	Median	UQ
London	0.05	0.47	1.19	0.03	0.13	1.47	0.03	0.21	1.45
South East	0.11	0.13	0.76	0.40	1.64	2.14	0.11	0.69	1.87
South West	0.04	0.27	0.89	0.36	0.73	0.98	0.16	0.68	0.98
Wales, Midlands, East of England	0.21	1.01	2.29	0.62	0.90	1.44	0.26	0.97	1.66
North East, North West	0.00	0.18	2.93	0.00	0.00	0.27	0.00	0.07	1.71
Scotland	0.13	0.22	0.50	0.15	0.23	0.40	0.14	0.23	0.46
Total	0.09	0.24	1.11	0.10	0.46	1.13	0.10	0.32	1.13
Very large firms	0.06	0.85	1.73	0.08	0.25	0.69	0.08	0.42	1.05

Longer term trends – what do you notice?

Fees per fee earner (£000)

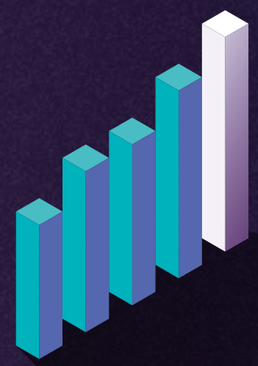
Fees per equity partner (£000)



Key questions

1. What do we need to do to enable fee earners to become more productive?
2. Are we training our fee earners properly so that they maximise their fee earning potential?
3. Are we confident about our pricing and can we charge more if we get the service right for the client?

Profit



Profit is the most important measure as it is the profit which is shared amongst the partners. It is amazing how many firms focus too much on fees earned and time recorded and not enough on profit. Historically this has been because firms have always found it easier to measure fees billed and time recorded than to calculate the profit earned for different types of work, for individual matters and for different fee earners.

A common starting point is to look at the profit available for the equity partners as a percentage of fee income. The helpful rule of thumb has always been that good firms will make 33%, with average firms making 25% and with under-performing firms doing even worse.

Table 7 provides some feedback on current performance. In total, the upper quartile score is 33%, the median figure is 23%, down from 24% last year and the lower quartile figure is 15% which is unchanged from last year. These numbers reinforce the validity of the traditional model and demonstrate that the legal profession is still performing broadly in line with long term trends. Last year I said that the challenge was to improve margins further and the danger was that firms will become complacent as fee income continues to grow. It is worrying that the median margin has now dropped for the first time in several years.

What is of perhaps greater interest in Table 7 are the significant regional variations. While the overall median figure is 23% in London it is 32%, in Scotland it is 27% but in the North East & North West it is just 17%.

Small firms have a median of 20% and large firms have a median margin of 25%. The very large firms have a median of 27%. It is interesting to see that the margins improve with size of firm which has not always been borne out in previous years. There is no reason in principle why the size of a firm should affect the profit margin. The key challenge in all firms is to make sure that the work being done is done in the most profitable way.

The key challenge in all firms is to make sure that the work being done is done in the most profitable way.

A better way of looking at profit is to calculate it as a profit per equity partner. Some surveys now calculate profits per partner but as non-equity partners are not risk takers and are effectively just higher paid fee earners, such a calculation is perhaps not as useful. Where the business in the survey is incorporated, we have used the number of shareholders to be the number of equity partners.

Table 7
Profit as a percentage of fees (%)

	Small			Large			Total		
	LQ	Medium	UQ	LQ	Medium	UQ	LQ	Medium	UQ
London	2	24	35	22	35	46	13	32	46
South East	12	18	29	18	25	30	17	23	30
South West	13	18	20	17	22	29	14	20	26
Wales, Midlands, East of England	9	17	26	18	21	24	10	20	25
North East, North West	13	19	23	6	11	24	10	17	24
Scotland	17	26	35	20	27	38	18	27	36
Total	13	20	31	18	25	34	15	23	33
Very large firms	16	25	30	23	30	38	19	27	35

Table 8 shows that the median profit per equity partner across all firms is £120,000 compared with £111,000 in the survey last year. Small firms achieve a median of £75,000 and large firms achieving a median of £164,000. In the very large firms the smaller ones achieve a median of £154,000 while the larger ones achieve a median of £242,000. The difference between the largest firms (£242,000) and the small firms (£75,000) is greater than threefold per equity partner at the median level. In the survey last year, the median figure was £111,000 and in the year prior to that it was £107,000 so the recovery to a figure in excess of £100,000 has been maintained. While the man in the street would say that £120,000 is a great deal of money, it should be remembered that this figure covers the salary of the equity partner for doing the job and the profit being earned from the business. One can argue forever about what is a fair salary for an equity partner but once this figure has been deducted from the profit per equity partner figure, the resultant true profit figure suddenly looks far less impressive in the vast majority of firms.

Not surprisingly there is once again very significant regional variance. The median figure for all firms is £120,000 but this drops to £81,000 for Wales, Midlands & East of England, but rises to £277,000 in London. The figure in the South East at £164,000 is nearly double the figure in the North East &, North West at £85,000 which again highlights a north south divide.

It is always interesting to look at the upper quartile figures to see what can be achieved. The figure for London at £529,000 is over four times the figure of £128,000 in North East & North West.

Table 9 looks at how profits have changed since last year. 39% of the autumn 2015 NatWest conference delegates predicted a 0-10% increase in profit with another 39% predicting no change in profits. The overall median increase is 6% which is down from 8% last year. The increase is fairly consistent across all of the regions. Small firms have fared much better at 11% while large firms have seen an increase of just 2%. The very large firms have seen an increase in profits of just 1%.

While firms would like their profits to be going up faster, it is good that they are continuing to rise faster than inflation. If overheads are now properly under control, then it is not unreasonable to expect to see some further significant increases in profits if steady growth can be achieved in fee income. Fees are up by 5% but profits have only increased by 6%. If the increase in fees arises from an increase in productivity, then profits would rise at 3-4 times the rate of fees increase. This is why there needs to be a more focused emphasis on productivity.

Table 8
Profit per equity partner (£000)

	Small			Large			Total		
	LQ	Medium	UQ	LQ	Medium	UQ	LQ	Medium	UQ
London	25	117	223	155	373	587	131	277	529
South East	65	77	160	141	201	284	77	164	233
South West	29	47	86	123	178	217	46	111	194
Wales, Midlands, East of England	25	57	94	72	137	163	41	81	143
North East, North West	56	74	105	107	183	256	59	85	128
Scotland	61	84	136	122	146	179	70	110	160
Total	45	75	121	123	164	283	63	120	202
Very large firms	129	154	205	155	242	526	138	178	354

Table 9
Profit per equity partner as a percentage of last year (%)

	Small			Large			Total		
	LQ	Medium	UQ	LQ	Medium	UQ	LQ	Medium	UQ
London	3	19	34	1	3	22	1	3	32
South East	12	16	33	1	1	6	1	9	16
South West	2	5	14	1	4	10	1	5	12
Wales, Midlands, East of England	7	10	24	1	2	4	2	6	12
North East, North West	5	8	15	1	7	7	5	7	14
Scotland	5	11	28	0	0	2	1	5	15
Total	5	11	28	0	2	6	2	6	15
Very large firms	1	1	3	0	0	1	0	1	2

A useful way of understanding and benchmarking profitability is with the following model:

	Small firm PEP £96,000	Large firm PEP £504,000
PEP = Gearing	4	5
X Hours	1,000	1,400
X Recovered rate/hour	£120	£240
X Profit margin	20%	30%

The first variable is referred to as either gearing or leverage. It is a number, representing the size of each team in the firm including the equity partner. So, if a partner manages two fee earners they have gearing of three while if they manage five fee earners they would have gearing of six. Clearly, the larger the team, the more it can bill and the more profit it can make. The reason why gearing can normally not get too high is to do with the complexity of the work. Only simple legal work can be done with huge gearing; more complicated work requires more supervision and experience.

The second variable is the annual recorded chargeable hours per fee earner. If everyone is busy and confident in recording their time, then the number will be high. If there is a shortage of work, or if people are not diligent over their time recording, then the recorded hours will be lower. It is not surprising that the firms who pay the most seem to get the most hours recorded. When the first two variables are multiplied together you are calculating the annual hours generated by each partner through their team.

The third variable is the recovered rate per hour billed. The higher this rate can be then the greater the profit margin will be. Clearly if work is complex it can demand a higher rate than if the work is routine. Some firms like to break this variable down into the recorded rate and the %age of this rate that has been billed. In other words:

Recovered rate per hour = recorded rate per hour x realisation %.

The multiple of the first three variables determines the fees billed by the partner in the year.

The final variable is the profit margin. This is the percentage of the fee which ends up as net profit. It is the efficiency with which a firm turns fees into profit. If the firm is efficient, then the net profit margin will be high while if there is inefficiency the margin will drop and can become negative.

The numbers used show that to go from a PEP of about £100,000 to a PEP of about £500,000 does not require a fivefold increase in all of the variables. Relatively small increases in one or more of the variables can deliver very significant improvements in profitability. This is why firms should regularly benchmark against their competitors so that they can identify where they can most easily improve.

Table 10 shows how gearing varies with size of firm and by region. The median figure for all firms is 3.94 compared with a figure of 3.20 in last years' survey. Only 3% of the autumn 2015 NatWest conference delegates predicted an increase in gearing of more than 20%; the majority anticipated no increase or an increase less than 10%. It is encouraging to see this number rising from last year as it should be possible to run with considerably higher numbers, as demonstrated by the very large firms. As work volumes pick up, many firms will need to focus on getting this variable back up to a more sensible figure as clients are not going to be willing to pay a partner to do the more routine work that needs to be done on a file. The figure should not however be increased until everyone is working at capacity as it is always better if additional work can be resourced with the existing fee earners, before recruiting new people. Perhaps firms should look at employing some more business development professionals to help fee earners to become more productive. Fee earners will never be fully productive if they have to spend too much time doing business development activities.

Table 10
Gearing (total fee earners per equity partner)

	Small			Large			Total		
	LQ	Medium	UQ	LQ	Medium	UQ	LQ	Medium	UQ
London	2.50	3.75	4.50	3.30	5.54	8.88	3.00	4.57	8.75
South East	3.83	4.55	5.63	4.08	4.57	5.72	3.97	4.57	5.75
South West	2.00	2.67	6.33	3.98	5.00	6.46	2.67	4.67	6.56
Wales, Midlands, East of England	2.38	3.13	3.67	2.87	3.54	6.19	2.64	3.37	5.23
North East, North West	2.69	3.58	4.19	5.29	12.25	12.95	3.00	4.00	6.25
Scotland	1.88	2.33	4.00	3.13	4.00	6.29	2.00	3.04	4.40
Total	2.00	3.00	4.42	3.31	4.58	7.04	2.54	3.94	6.00
Very large firms	3.88	5.00	7.33	3.33	5.00	7.03	3.48	5.00	7.24

It is particularly interesting to see that the median figure in small firms is 3.00 while in large firms it is significantly higher at 4.58. The figure gets even higher in the very large firms where the median is 5.00. Once again there is an insight into what might be possible if the upper quartile figures are reviewed. In large firms, the upper quartile figure is 6.00 but this varies regionally and goes up to 8.75 in London. This figure is over two times higher than the median for all firms of 3.94.

If gearing is to improve then perhaps there needs to be a rule that when a file is opened at least two fee earners must be allocated to the file. It is too easy for one person to do everything and the consequences will be lower gearing and poor efficiency.

Staffing ratios are clearly important and all firms need to have the right mix of fee earning and non-fee earning staff. Traditionally it was not uncommon to find that firms had about the same number of fee earners as they did support staff. In recent times, while secretarial numbers have been falling, firms have found it necessary to recruit new people in business development, information technology and other management roles so in aggregate maybe nothing has really changed. This is very different to what is seen in large accountancy firms where fee earners often account for 75% of total headcount.

Table 11 provides an update on the relationship between fee earners and non-fee earners.

Across all firms, 53% of people are fee earners meaning that 47% are non-fee earners which reinforces the traditional view of a 50/50 split. In small firms the figure is 50%, this rises to 56% in large firms and to 61% in the very large firms which could suggest that they have achieved some real economies of scale. There is however a danger that fee earners will have to spend too much time on non fee earning tasks and this could affect productivity.

There are significant regional variances too with London seeing a median figure of 68% fee earners compared with South West at 41%.

If clients cannot see the effort which has been put into their affairs, then they are unlikely to pay for this effort.

Fees will only be maximised if fee earners are recording all of their time. If clients cannot see the effort which has been put into their affairs, then they are unlikely to pay for this effort. Full time capture is the most basic thing for fee earners to do properly but most fee earners still massively under record their time. Different firms have different working cultures but most fee earners are asked to work a minimum of 7.5 hours per day. Given that when holidays (seven weeks including Bank Holidays) and weekends are taken into account there are still 220 working days in a year this suggests a capacity of 1,688 hours per year. Fee earners will spend time on business development, know how, training and may have some sickness but equally they will often work additional hours either in the office or away from the office.

Table 11
Fee earners as percentage of total headcount (%)

	Small			Large			Total		
	LQ	Medium	UQ	LQ	Medium	UQ	LQ	Medium	UQ
London	60	67	75	58	68	73	59	68	74
South East	43	48	55	35	47	63	39	48	59
South West	32	36	53	37	49	60	33	41	61
Wales, Midlands, East of England	39	42	53	42	48	52	40	45	52
North East, North West	36	47	53	44	49	62	40	49	58
Scotland	32	52	60	51	61	73	38	55	66
Total	36	50	61	44	56	68	40	53	66
Very large firms	43	50	66	57	64	74	48	61	71

Table 12 shows the level of chargeable time being recorded and highlights that considerable time is being lost. The overall median figure of 866 hours per fee earner equates to 3.9 hours per working day. This does not tally with how most fee earners tell you that they are working hard on client matters for most of every working day and that this often continues when they leave the office as it is increasingly easy to work remotely with the help of technology. There does not appear to be much regional variance in these figures. The figures are down on last year when the median was 1.000 hours. Only 1% of the autumn 2015 NatWest conference delegates predicted this 10-20% decrease in recorded chargeable hours; 92% of conference delegates anticipated an increase or no change. With increasing levels of fee income, it would have been expected that this figure would rise. A possible explanation is that fee earners are still nervous about recording all of their time because they worry about the prospect of increased write-offs.

Clients continue to put all suppliers, including their law firms, under pressure on fees. Indeed, commercial clients are often better at negotiating fees than solicitors, many of whom have never really had to negotiate hard on fees until relatively recently. There continues to be significant push back on charging by reference to hourly rates and clients and the courts are looking for more certain and creative ways of charging. It seems unlikely that this price pressure is going to disappear anytime soon.

Table 13 shows the recovered rate per hour which is being achieved. The median recovered rate for all firms is £161 which represents a decrease of £1 on the figure in last years' survey and which supports that price pressure is not going away. Just 8% of the autumn 2015 NatWest conference delegates predicted this 0-10% decrease in recovered rate; 51% thought that there would be no change and a further 32% expected an increase from 0-10%. If the realisation rate were 80%, which is a common figure, this is implying a headline rate of £201 with a further £40 discount at the point of billing. Small firms have a median figure of £155 while large firms have a median of £169. The figure for very large firms is higher again at £175 but it is surprising to see that the median for the largest firms is only £176. This can be explained by the fact that the very large firms have higher levels of gearing as seen in Table 10. As gearing increases this will always tend to reduce the average recovered rate per hour.

Clients continue to put all suppliers, including their law firms, under pressure on fees.

Table 12
Chargeable hours per fee earner

	Total		
	LQ	Medium	UQ
London	745	1,003	1,244
South East	169	650	829
South West	635	689	817
Wales, Midlands, East of England	795	1,000	1,000
North East, North West	688	1,005	1,100
Scotland	709	841	1,204
Total	660	866	1,050
Very large firms	689	963	1,013

Table 13
Recovered rate per hour by size of firm (£)

	Small			Large			Total		
	LQ	Medium	UQ	LQ	Medium	UQ	LQ	Medium	UQ
Total	110	155	176	132	169	245	127	161	232
Very large firms	145	175	334	148	176	276	146	175	287

Getting a better recovered rate per hour is more likely if firms make good use of IT. Before good use has to be made there needs to be investment in IT. We asked the firms in our survey whether they had invested in IT in the last 12 months. The results are in **Table 14** below. In total 73% of firms had invested in IT but this fell to 62% in small firms and rose to 83% in large firms and 94% in firms with fee income in excess of £10m. 84% of firms in London had invested in IT while this dropped to 57% in the North East & North West.

Table 15 calculates what the PEP figure would be for firms of different size if they achieved lower quartile, median or upper quartile performance for each of the four drivers of profitability. While it would be difficult to be the best at everything it should be possible to achieve upper quartile performance at everything. The table shows that achieving upper quartile performance will nearly always deliver a PEP figure of over ten times of what would be achieved at the lower quartile level.

Table 14
Percentage of firms investing in IT in the last 12 months (%)

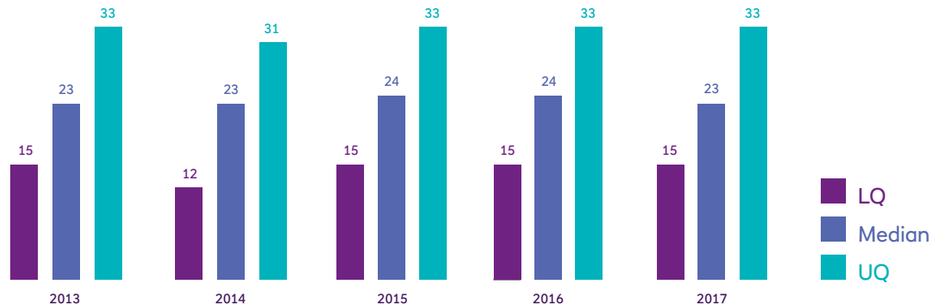
	Small	Large	Total
London	77	87	84
South East	67	60	63
South West	40	81	65
Wales, Midlands, East of England	62	91	77
North East, North West	50	70	57
Scotland	67	92	75
Total	62	83	73
Very large firms	79	94	87

Table 15
Profit per Equity Partner (£000) – using median across all regions

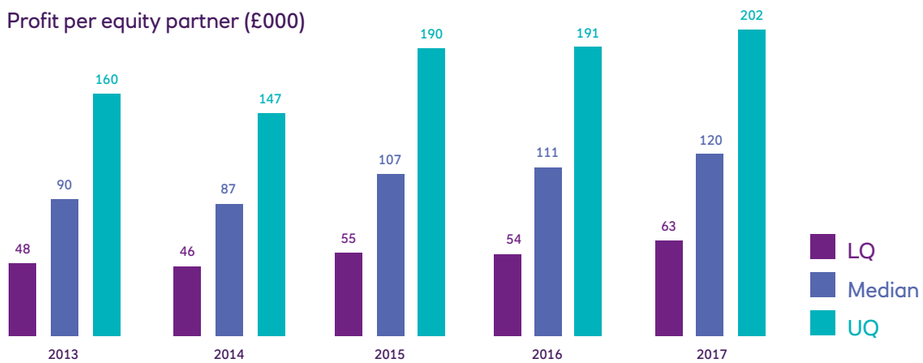
	Small			Large			Total		
	LQ	Medium	UQ	LQ	Medium	UQ	LQ	Medium	UQ
Gearing	2.00	3.00	4.42	3.31	4.58	7.04	2.54	3.94	6.00
Hours	667	750	1,100	658	901	1,035	660	866	1,050
Recovered rate (£)	110	155	176	132	169	245	127	161	232
Margin %	13	20	31	18	25	34	15	23	33
Total PEP (£000)	19	70	265	52	174	607	32	126	482
Very Large Firms									
Gearing	3.88	5.00	7.33	3.33	5.00	7.03	3.48	5.00	7.24
Hours	583	824	1,030	840	985	1,010	689	963	1,013
Recovered rate (£)	145	175	334	148	176	276	146	175	287
Margin %	16	25	30	23	30	38	19	27	35
Total PEP (£000)	52	180	756	95	260	745	67	228	737

Longer term trends – what do you notice?

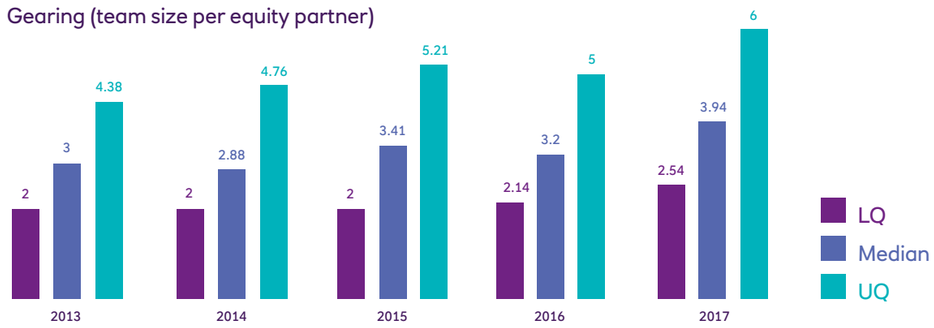
Profit as a percentage of fees



Profit per equity partner (£000)

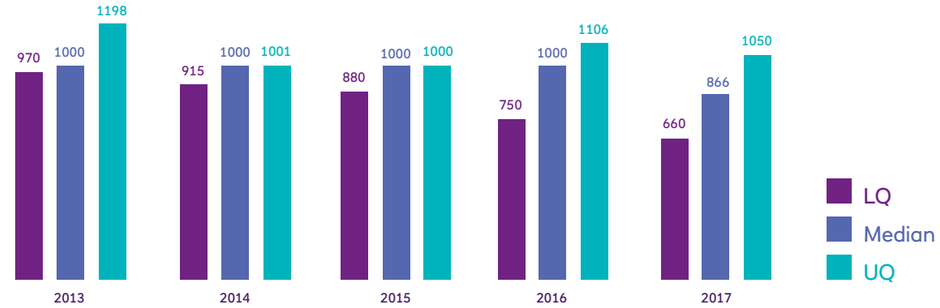


Gearing (team size per equity partner)

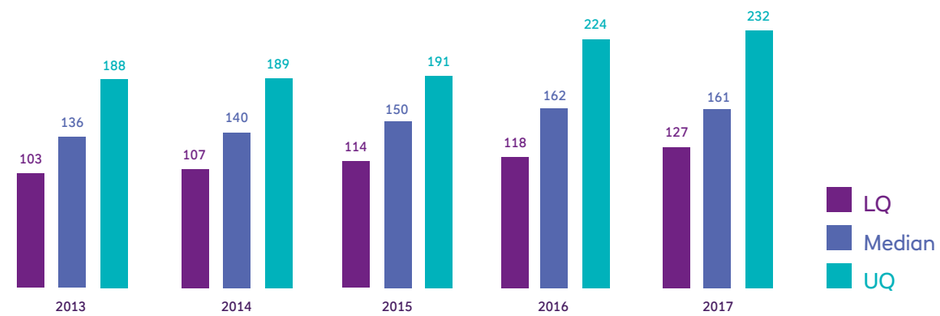


Longer term trends – what do you notice?

Recorded chargeable hours per fee earner



Recovered rate per hour (£)



Key questions

1. Have we benchmarked our performance against comparable firms and have we identified where we are below the upper quartile point?
2. Are we under recording time and not showing clients the full extent of our efforts?
3. How can we get a better rate per hour for what we do; do we understand creative fees and client expectations on service?
4. Do we use matter planning tools which help us to understand the profitability of the work we are doing?
5. Do we have a clear strategy and are we making progress in getting it implemented?
6. Is profit sharing properly linked to performance and attainment of our strategic goals?

If cash flow could be improved, then there would be less pressure on the firm and lower levels of capital would be required.

Lock-up

The vast majority of legal businesses fail to manage lock-up effectively and, as a consequence, provide far too much credit to clients which in turn will potentially generate cash flow problems. Having said that, lawyers are naturally cautious and do not like borrowing money. The consequence of all of this is that firms will often require considerable capital from the partners and there will need to be some delay between generating profits and those profits being distributed to the partners. If cash flow could be improved, then there would be less pressure on the firm and lower levels of capital would be required.

Table 16 shows the amount of WIP days being carried in firms. This is a measure of how long it takes from the recording of an hour to the billing of that hour. The total median figure is 50 days (down from 56 days last year) while the upper quartile position is 27 days and lower quartile performance is 85 days. It is interesting to see how performance worsens as firms get larger. The median for small firms is 44 days, for large firms 55 days. There is also some variance by region with the South East doing equal best at 31 days while Wales, Midlands, East of England take 73 days.

The figures are consistently high and firms should begin to act because when work volumes pick up there is always a tendency to focus on finding the resources to get the work done and less focus on managing billing and WIP.

Table 16
WIP days

	Small			Large			Total		
	UQ	Median	LQ	UQ	Median	LQ	UQ	Median	LQ
London	36	49	85	25	65	101	27	55	102
South East	21	30	49	19	31	37	19	31	42
South West	41	48	59	14	45	84	24	46	80
Wales, Midlands, East of England	22	59	90	46	87	103	40	73	103
North East, North West	29	56	82	42	118	240	33	59	123
Scotland	15	34	50	38	56	65	24	46	59
Total	25	44	76	28	55	96	27	50	85
Very large firms	19	40	72	46	67	96	27	53	90

Table 17 provides feedback on debtor days. This is a measure of how many days it takes to get a bill paid from when it is issued. The median figure is 51 days which is three days higher than last year, with it falling to 26 days at the upper quartile level and rising to 82 days at the lower quartile level. Only 10% of the autumn 2015 NatWest conference delegates predicted a weakening in debtor days. Once again it is interesting to see how the larger firms do worse. The median for small firms is 42 days, for large firms 61 days and for very large firms 79 days. While the very large firms tend to be more profitable than smaller firms they are not as successful at managing cash flow. This is probably because more people need to be managed and perhaps more time should be spent training fee earners on what they should be doing to manage cash flow more effectively and to get clients to settle their bills.

Table 18 provides statistics on total lock-up figures. This measures in days how long it takes from a fee earner recording an hour to the cash being received from the client. It can be seen that the total median figure is 113 days which is four days more than last year. There is considerable regional variance with the median in North East, North West being 141 days while in the South East it is just 82 days. There is no reason why so much credit should be given and it is simply a culture that has persisted for many decades.

All fee earners need to think about what they can do with their clients to increase money on account, to accelerate billing and to take a more active role in credit control.

For small firms the figure is 84 days, for large firms it is 131 days and for very large firms it is 142 days. This evidence confirms yet again that larger firms struggle to manage cash flow compared to smaller firms.

Table 17
Debtor days

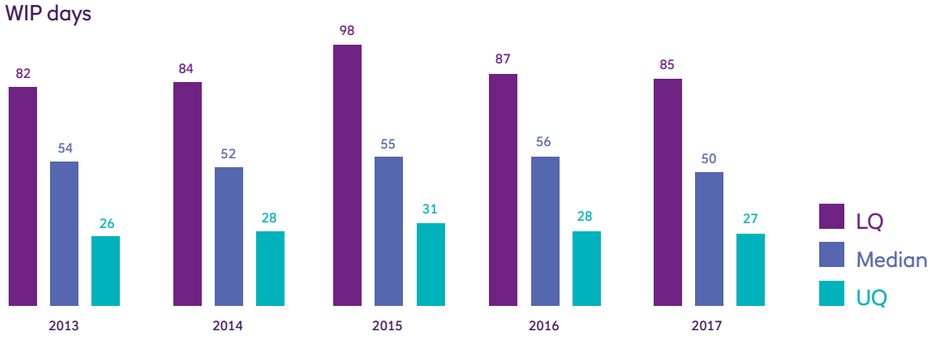
	Small			Large			Total		
	UQ	Median	LQ	UQ	Median	LQ	UQ	Median	LQ
London	40	67	77	33	78	102	34	68	98
South East	28	39	52	35	64	124	30	47	77
South West	23	30	61	22	55	80	22	38	72
Wales, Midlands, East of England	22	41	52	40	50	76	27	48	59
North East, North West	30	55	105	52	65	114	43	57	106
Scotland	16	34	66	46	67	115	21	49	73
Total	21	42	66	37	61	101	26	51	82
Very large firms	45	69	128	51	79	110	49	79	118

Table 18
Total lock-up days

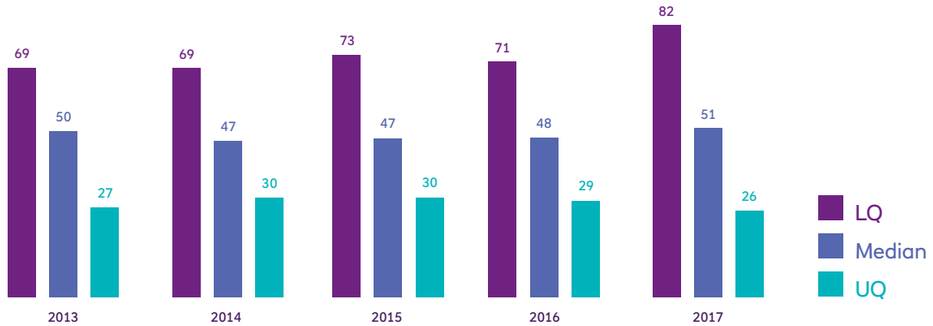
	Small			Large			Total		
	UQ	Median	LQ	UQ	Median	LQ	UQ	Median	LQ
London	92	109	142	116	144	166	104	135	162
South East	65	73	95	64	99	144	64	82	113
South West	72	78	89	81	112	150	72	96	139
Wales, Midlands, East of England	74	108	149	100	130	164	87	122	158
North East, North West	78	104	153	113	215	385	83	141	238
Scotland	47	66	102	106	127	158	51	86	129
Total	62	84	123	94	131	165	73	113	154
Very large firms	96	126	156	119	154	188	111	142	169

Longer term trends – what do you notice?

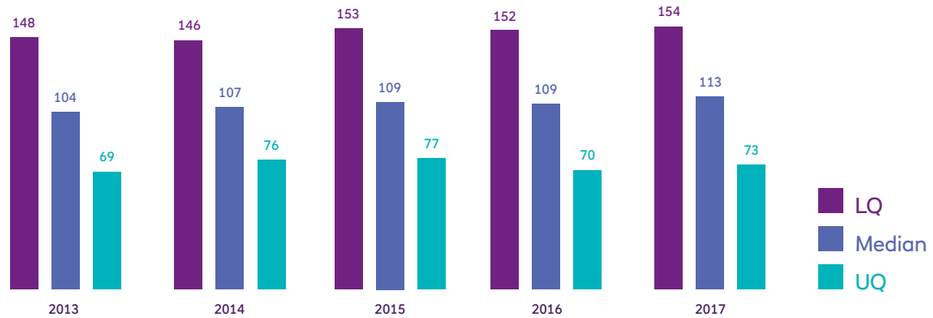
WIP days



Debtor days



Total lock-up days



Key questions

1. Given that clients don't want a shock when they are billed, why do we wait so long before we talk about money?
2. Do fee earners have the necessary management information available to manage lock-up effectively?
3. Are the appropriate carrots and sticks in place to deliver improved lock-up?
4. Have fee earners been trained to manage lock-up effectively?

Not making a profit is unlikely to cause the collapse of a firm in a hurry but running out of money can cause immediate failure.

Finance

Firms fail when they run out of money. Not making a profit is unlikely to cause the collapse of a firm in a hurry but running out of money can cause immediate failure. All firms should therefore monitor their bank balance at all times and prepare regular cash flow forecasts to make sure that they can live within their agreed bank facilities. Banks make money out of lending to businesses but they are unlikely to lend to anyone who comes knocking at their door which is on the verge of collapse. Law firms have always been fairly prudent and do not traditionally feel comfortable with too much debt.

Table 19 shows the year end bank balance of firms. The median figure in total is that there is £94,000 (last year £54,000) in the bank. There is some regional variance in this figure with the London figure being £355,000 and the figure in Wales, Midlands, East of England being £53,000.

Given that the lower quartile bank balance is £5,000 this means that about a quarter of firms were overdrawn at the year end.

Table 19
Year end bank balance (£000)

	Small			Large			Total		
	LQ	Median	UQ	LQ	Median	UQ	LQ	Median	UQ
London	22	96	320	94	552	1,365	64	355	1,009
South East	48	81	98	281	472	678	87	197	491
South West	–83	14	154	4	170	962	–65	55	237
Wales, Midlands, East of England	6	35	116	–529	89	320	–37	53	182
North East, North West	25	78	156	–388	–66	440	–35	63	193
Scotland	4	26	170	302	618	1,550	9	86	510
Total	4	57	156	12	333	962	5	94	442
Very large firms	–7	327	538	15	1,233	2,408	1	438	1,495

Table 20 looks at the capacity to borrow more money, compared to annual fees, when considering the year end office account balance and the overdraft facility available. It is interesting to see that the median figure, at 11% of fee income represents about 40 days of income. The lower quartile point is about 22 days and the upper quartile point represents about 66 days of income. This highlights how even though the majority of firms are not currently in overdraft, just how quickly and easily many firms could become insolvent if their lock-up deteriorates by relatively small amounts.

Firms can become less reliant on bank finance if more partner capital is introduced and retained. One way of benchmarking partner capital is to express it as a percentage of annual fees. Given that the median firm has total lock-up per Table 18 of 113 days this could be financed by having partner capital equal to 31% of fees.

Table 21 shows the position for firms and the overall median figure is 27%. On this measure, North East, North West firms have more capital than in any other region at 35% of annual fees. Small firms have a median figure of 24%, large firms have a median of 29% and very large firms have a median of 32%; this is in line with the higher levels of lock-up seen in larger firms in Table 18.

Banks are more comfortable where the percentage of borrowings against partner equity is lower and where the partners can demonstrate that they clearly have a level of personal financial commitment to the firm.

Table 20
Capacity in overdraft as a percentage of fees (%)

	Small			Large			Total		
	LQ	Median	UQ	LQ	Median	UQ	LQ	Median	UQ
London	12	14	25	8	16	26	9	14	26
South East	3	8	12	10	12	15	6	11	13
South West	5	9	14	5	10	22	5	10	19
Wales, Midlands, East of England	6	10	13	6	9	16	6	9	15
North East, North West	11	15	21	4	5	23	6	14	22
Scotland	7	10	17	7	10	15	7	10	16
Total	6	11	18	6	12	18	6	11	18
Very large firms	6	11	14	5	10	20	6	10	17

Table 21
Partner capital as a percentage of fees (%)

	Small			Large			Total		
	LQ	Median	UQ	LQ	Median	UQ	LQ	Median	UQ
London	20	30	47	25	37	44	25	34	44
South East	14	23	38	13	16	35	13	19	35
South West	10	17	39	16	23	31	10	21	33
Wales, Midlands, East of England	11	19	31	20	29	40	14	23	37
North East, North West	11	28	35	17	21	34	11	24	36
Scotland	15	27	40	26	35	44	18	32	42
Total	12	24	39	18	29	41	15	27	41
Very large firms	18	28	41	25	33	43	20	32	42

Table 22 shows the percentage of bank borrowings (including borrowed partner capital) as a percentage of real partner capital. The lower quartile figure for small firms is 0% showing that there is no debt while the median figure for all firms is 35%. The median figure of 35% is down from 44% in the previous year and could suggest that capital accounts are being increased with profits being retained. The upper quartile figure for large firms in North East & North West is 164% showing borrowings which are in excess of real partner capital. Firms in this position should think again about their facilities, the amount of capital being provided by the partners and the ability of the firm to manage lock-up as their bank may become less happy to continue to provide so much finance in future.

Many firms carry significant client account balances. While this money does not belong to the firm, a firm is able to keep any interest earned over and above what they have detailed in their interest policy to clients. The returns in recent years have been considerably lower because of long term low interest rates but this might change in the future. The amount of money held is also an indicator of how busy a firm might be and with what value of transactions.

Table 23 shows the client bank balance at the year-end as a percentage of annual fees.

The median figure for small firms at 181% is significantly higher than the median figure for large firms at 76%. The median figure for very large firms is lower again at 57%. In the South East the upper quartile figure is 369% representing 3.69 years of fee income. The median figure for all firms is 129% (compared with 160% last year) with regional variances and peaking at 247% in the South East. The North East & North West has the lowest median figure of 10% which might suggest that these firms are now doing less property work than in some of the other regions. Given that the survey covers firms with combined fees of £1.43bn, this suggests that if client money balances are 129% of fees that client money held will be about £1.84bn.

Table 22
Percentage of partner capital borrowed (%)

	Small			Large			Total		
	LQ	Median	UQ	LQ	Median	UQ	LQ	Median	UQ
London	11	29	52	13	36	74	12	36	74
South East	0	0	3	6	37	88	0	9	51
South West	17	70	122	11	63	120	14	63	123
Wales, Midlands, East of England	0	15	54	6	28	141	0	16	79
North East, North West	34	57	106	58	103	164	37	66	126
Scotland	0	27	45	28	61	119	7	32	62
Total	0	30	59	11	50	113	6	35	92
Very large firms	20	57	112	15	46	104	16	54	112

Table 23
Client bank balance as a percentage of fees (%)

	Small			Large			Total		
	LQ	Median	UQ	LQ	Median	UQ	LQ	Median	UQ
London	54	221	664	13	37	87	21	48	208
South East	160	239	439	164	249	307	140	247	369
South West	162	196	369	71	134	176	84	164	207
Wales, Midlands, East of England	54	153	307	64	203	294	57	183	294
North East, North West	0	10	118	3	18	60	0	10	94
Scotland	74	260	408	27	60	156	44	148	302
Total	48	181	367	26	76	219	32	129	278
Very large firms	21	74	247	22	40	92	21	57	201

There have been some significant thefts from client account in recent months and all firms should be looking again at what they have done to best minimise the risk of this happening to them. Organised crime gangs will continue to target these funds. We asked the firms in the survey if they had suffered a cyber-attack or fraud related loss in the last 12 months.

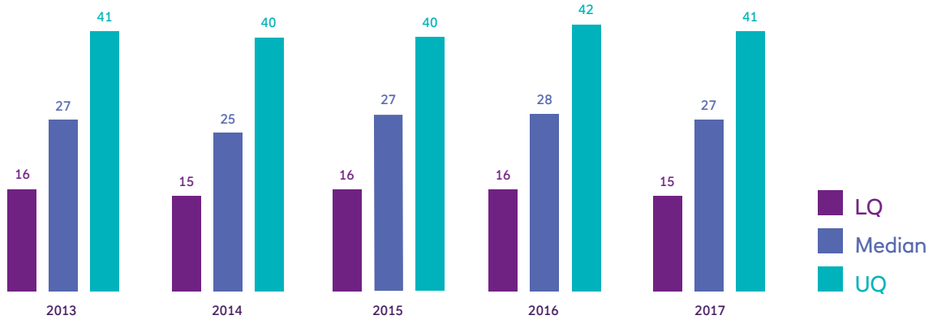
Table 24 shows the results and it is interesting to see that 24% of all firms have suffered in this way. The figure is 16% for small firms, 31% for large firms and 28% for very large firms. There are some significant regional differences with the North East & North West suffering in 37% of firms while in Scotland just 9% of firms suffered in this way.

Table 24
Percentage of firms that have experienced a cyber-attack or fraud-related loss in last 12 months (%)

	Small	Large	Total
London	15	45	36
South East	18	29	24
South West	11	19	16
Wales, Midlands, East of England	29	30	30
North East, North West	25	60	37
Scotland	7	13	9
Total	16	31	24
Very large firms	41%	35%	38%

Longer term trends – what do you notice?

Partner capital as a percentage of fees



Key questions

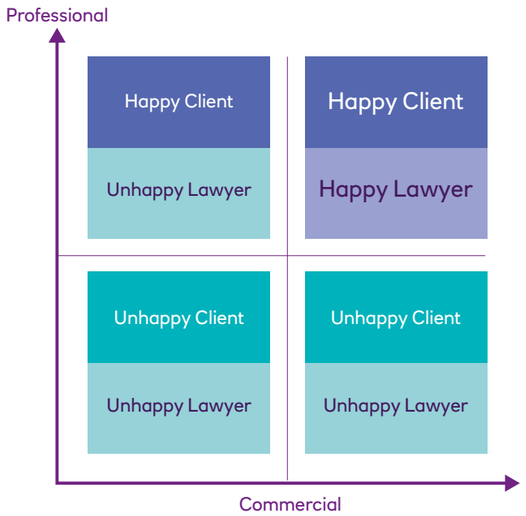
1. Do we have sufficient capital to run the business now and will we need more capital as the firm grows?
2. Is it time to look again at our legal structure and how capital is to be retained within the firm?
3. Is it right that we aim to fully distribute profits?
4. Do we need to think again about how quickly new partners are asked to contribute capital and how quickly departing partners can extract their capital?

Using the survey to improve performance

Having worked with so many firms for so many years, it is clear to me that there are two prerequisites that need to be satisfied if a firm is to be profitable over a long period of time. The first is being professional and the second is being commercial. Clients will only instruct lawyers who they believe to be professional in the first place. If this proves to be untrue then the client is likely to question the fee, is highly unlikely to use the firm again and would probably speak badly about the firm if ever questioned about it.

Most firms understand professionalism and while everyone can improve there are many firms who score well on this measure. The reason why so many firms struggle to meet their financial aspirations is that they often let themselves down when it comes to being commercial. For a law firm, being commercial starts with having budgets that set targets for the key KPIs, and then having regular, timely and accurate management information which is available to everyone and which encourages everyone to constantly strive to find a way of working in a more profitable way.

The diagram below shows the outcomes which arise when firms are, or are not, professional and commercial.

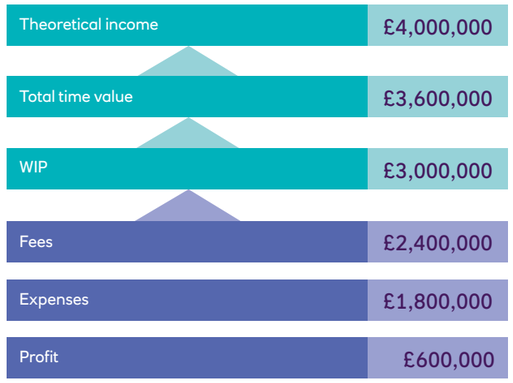


Being commercial also means recognising, understanding and acting on the importance of statements such as the following:

- Additional income does not always deliver an increase in profit.
- Higher profits can be earned with no increase in fees.
- Matter and client profitability need to be understood in addition to practice group and firm profitability.
- A profit is of no use until it has been realised as cash.
- Resourcing work at the right level drives efficiency.
- If know-how is not capable of being shared, then it's full value will never be realised.
- Some clients will always be loss making.
- New work needs to be profitable.
- Clients don't like nasty surprises;
- Lawyers need to manage their matters pro-actively.

The reason why so many firms struggle to meet their financial aspirations is that they often let themselves down when it comes to being commercial.

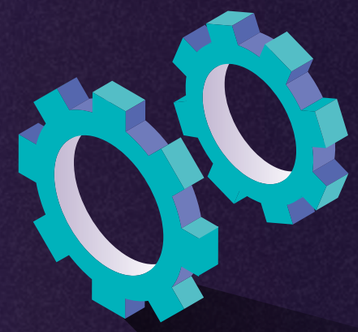
If you reflect on this survey, you will appreciate that a typical 5-partner firm makes a profit of £600,000 on annual fees of around £2.4m. This creates a PEP of £120,000, which might be enough for the firm to survive, but which could be increased dramatically with a focus on being more commercial. Just take a look at the diagram below. The fees of £2.4m were raised having given a billing discount of 20% from the WIP created of £3m. It is even worse when you appreciate that there was an additional time recording discount of £600,000 as a further 20% of time spent on matters was never recorded to the file.



What needs to be done to stop these discounts? Firms need to be more commercial and in particular they need to look at ways of improving lawyer productivity. You might therefore find it interesting to look at our productivity quiz which follows.

And of course, headline rates were discounted by 10% at the beginning when clients enquired about and challenged the normal rates. By the time you add together the pricing, time recording and billing discounts the firm has given away £1.6m which could have been added to the profit without any increase in costs. Learning to realise some of this additional income is likely to give a far better result than trying to strip out any further costs. Cost cutting beyond a certain level is counter productive and leads to inefficiency and a damage to the service being offered to clients.

Improving productivity – the best way of increasing profitability



Nobody wants to work harder, but everyone would like to produce more in the same or a shorter working day. This is an issue which the economy generally needs to tackle and it is definitely an issue for most professional firms too. Gone are the days where you could just do a task and charge a client for the time it took; clients now see that everything has a value and there is therefore a premium to be earned for efficiency. We have devised a short 30 question questionnaire to help you to identify where productivity is weak and what needs to be done if you are going to improve upon current performance levels. If you can answer "yes" to every question, then you are probably doing perfectly well already.

Capturing effort

Everyone needs to capture all of their effort so that the firm understands what everything costs. Understanding the cost of everything is vital if efficiency is to be understood and improved.

1. Does the firm have a detailed time recording policy which clearly outlines when and how fee earners are expected to record their time?
2. Is the policy supported by a detailed FAQs document which gives detailed explanations of how common grey areas of time recording are to be captured?
3. Does the firm have a comprehensive list of codes so that all time can be captured?
4. Have fee earners been trained how to write narratives that properly explain the value delivered to clients rather than just focusing on the processes undertaken?
5. Is there pressure to under record time when estimates are being reached?
6. Are fee earners encouraged to attach billing notes to their time entries so that there can be a way of billing clients fairly?
7. Can everyone always see how they are doing compared with the expectations that have been set for time capture?

Improving efficiency

Once we know where the time is going, it is possible to think about what needs improving and the best ways of improving efficiency.

1. Have you got the correct staff structure in place so that all work is delegated to the right level?
2. When files are opened do you always ensure that more than one fee earner is allocated to the file so that we are always thinking about who should do each task?
3. Is all of your knowledge properly documented in a way that all fee earners can recycle the knowledge of other fee earners?
4. Could you get clients to do more of the information gathering and administration that is necessary for you to do your work?
5. Could you ask other people, outside of the firm, to do some of our work without there being any dilution in quality?
6. What do you do to ensure that matters stick to sensible timescales and what happens when matters delay or overrun?
7. How do you manage other people as the way in which they choose to behave can have serious implications for you in terms of the cost you will incur to complete a matter?
8. Do you regularly benchmark how long it takes your fee earners to perform tasks compared to their colleagues and fee earners in other firms?
9. Do you use a matter planning tool that helps you to understand and manage the cost of running files?

Attracting work with better pricing

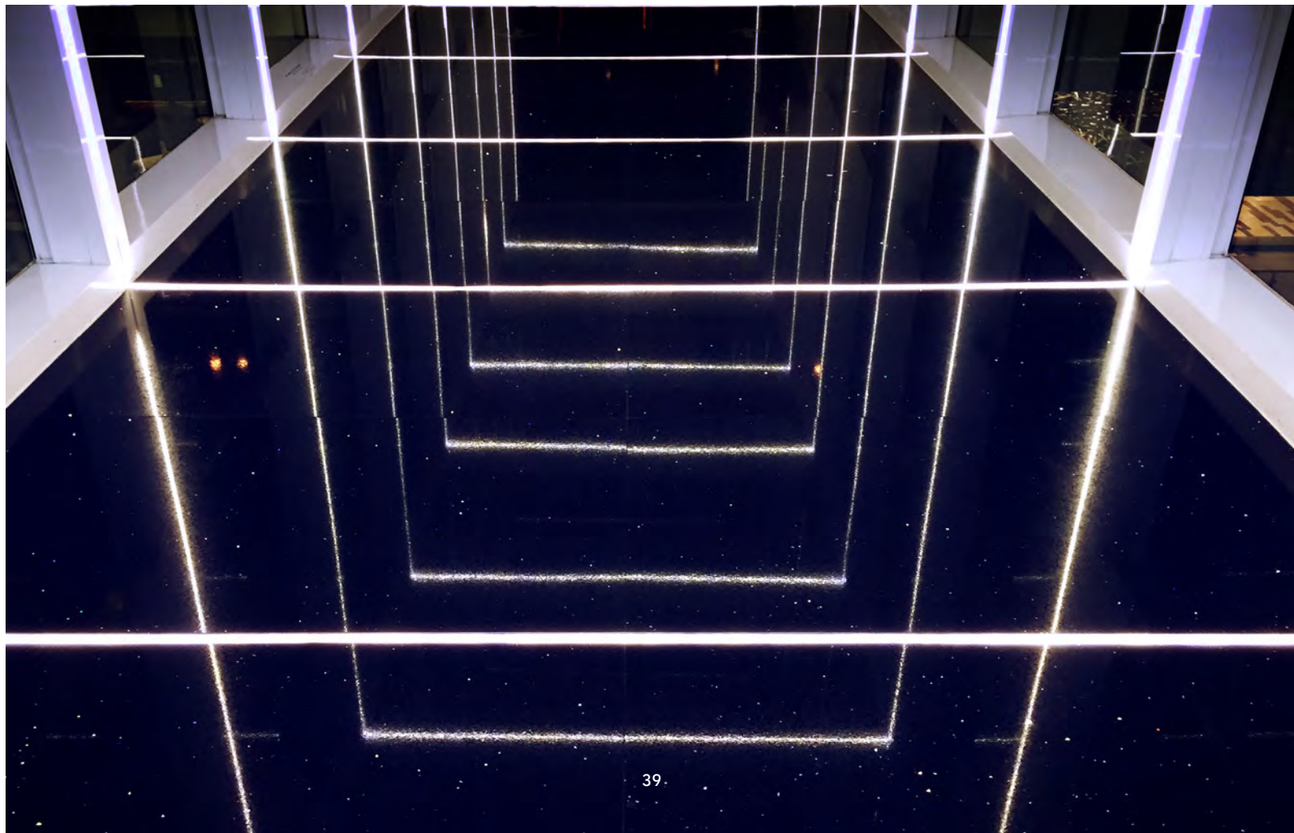
Clients will not instruct you if they are unhappy with the fee arrangement. This does not mean that you need to be cheap but it does mean that you need to think again about how you are going to charge and what the client values.

1. Do you feel comfortable when clients ask you to be more creative with your fee arrangements?
2. Are you good at giving clients genuine choice over fee arrangements so that they can make a choice from your options, rather than needing to get quotes from other firms?
3. Are fee earners good at understanding what clients value and linking fee arrangements to these measures of value?
4. Have you tested whether you are really charging as much as you could or have you been listening too much to your clients?
5. Is the differential between your highest and lowest charge out rates always encouraging work to be done at the right level?
6. Does your website give clear examples of how you can offer alternative fee arrangements to clients?
7. Do you pro-actively talk to clients about alternative ways of charging for their work?

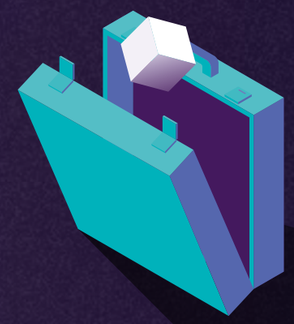
Fee negotiation

Most professional people feel uncomfortable discussing fees. Sophisticated clients can see this and use this to their advantage. They like to reduce your fees to much lower levels with minimal effort.

1. Does everyone understand the impact on profit of a 10% discount off a fee or a billing rate?
2. Is there guidance that has been provided to show fee earners what can be done when fees come under pressure?
3. Is everyone comfortable with a "walkaway point" and is this used when negotiating fees?
4. Do all fee earners appreciate how trading can be better than discounting?
5. Are there sound systems in place so that any scope creep would be immediately identified so that it can be shared with the client?
6. Would all fee earners link fee negotiation into cash flow and seek to get earlier or up-front payment, in return for lower or more certain fees?
7. Are fee earners good at getting feedback from clients as matters progress so that clients can never really say that they are not entirely happy at the end of a matter?



Conclusion



We have already detailed how important it is for all firms to benchmark themselves against their peers in order to assess how well they are performing and to identify how financial performance can be improved.

We hope that this report provides the robust data required to undertake effective benchmarking, and that it offers practical support on how to interpret the outputs and implement strategies to deliver improved financial performance.

To aid you in this objective, the following table gives you the ability to examine your own firm's performance on a comparative basis against the upper quartile output across total firms.

For some, the results may be worrying but will hopefully motivate the implementation of an action plan. For others, this exercise will serve to simply endorse the business plan and operational model already in place.

Research and methodology

We analysed the financial data, representing the performance of 269 legal firms operating in the small-to-medium enterprise (SME) space, employing 16,000 people in total (including 1,877 partners), and covering year-end 2016. The total for all regions in each table represents the aggregate figure for all participating firms, across all regions. Further details of the methodology of this report are available on request.

For the purposes of this report, those firms with fees of less than £2.25m are described as 'small', while those with fees in excess of £2.25m are described as 'large'. The report also refers to 'very large' firms, those with fees in excess of £10m.

How does your firm compare?

Find out for yourself

Use the table below to compare your business's key metrics to UK averages. Whether you find areas to improve on, or your figures surpass national averages, contact us for added help and support.

	UQ	Firm's ratio	Actions required
Fees per equity partner (£000)	858		
Fees per fee earner (£000)	179		
Profit as % of fees (%)	33		
Profit per equity partner (£000)	202		
Chargeable hours (per year)	1050		
Recovered rate per hour (£)	232		
	LQ	**Firm's ratio**	**Actions required**
WIP days	27		
Debtor days	26		
Total lock-up (days)	73		

Want to know more?

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 Steve Arundale, Head of Commercial Professional Sectors, NatWest:

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