

PEER MONITOR INDEX

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PMI Edges Upward in Second Quarter Law Firm Market Demand, Rates Outpace Expense Growth

The HILDEBRANDT INSTITUTE'S **PEER MONITOR INDEX (PMI)**¹ rose two points to 62 in the second quarter – its third consecutive quarterly gain. Continued strengthening in law firm demand and better-than-expected rate growth combined to surpass rising expenses, boosting the PMI to its highest level in several quarters.

The mix of positive factors in the market shifted slightly, as both demand and rate growth increased. Demand² for legal services was up 2 percent in the second quarter. Rates were up 3.2 percent compared with the same period a year earlier.

However, firms also saw continued increases in costs, as both head count and overhead expenses rose. Top-line growth outpaced cost increases, improving profit margins and productivity. But caution is in order, as costs continue to rise in anticipation of further revenue growth that may or may not meet expectations in future quarters. In addition, this level of rate performance is not expected to be sustained for the rest of the year.

Individual firm performance is uneven, suggesting that gains are not being seen across all firms, and indeed some firm strategies are producing weak results amidst choppy economic conditions.

Demand by Practice Areas

Litigation demand was up 2.9 percent – the third consecutive quarterly gain. Strength in litigation demand has been a major driver of the improvement seen in the market over the past year, as it represents about one-third of industry demand. IP litigation was up sharply compared with a year ago, rising 6 percent, while patent work was up 3 percent.

Transactional practices were generally stronger, as they have been for the last several quarters. M&A and structured finance showed good growth, up 3 percent, while general corporate work was up 2 percent, and capital markets was flat for the quarter. Real estate and labor and employment were also up about 3 percent, while bankruptcy continues to decline from the peaks seen in 2009, down 6 percent from the same time a year ago.

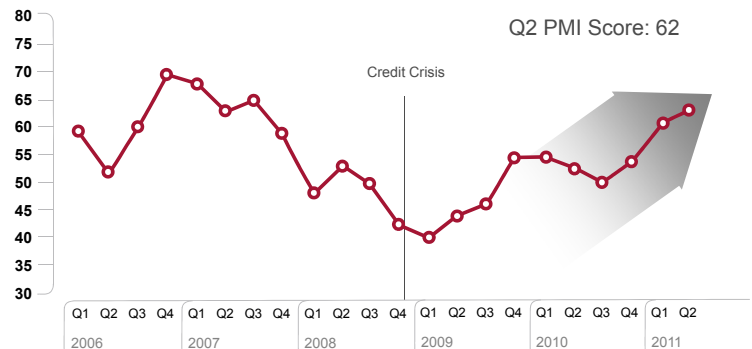
Performance by Market Segments

Firm performance varied across market segments. Demand growth was strongest for Am Law 100 firms. In addition, head count growth was restrained, boosting productivity.

¹ The PMI is a composite index score, representing the quarter-over-quarter change in drivers of law firm profitability, including rates, demand, productivity and expenses. Positive factors driving firm profitability will produce a higher score. A score exceeding 65 generally indicates a healthy operating environment.

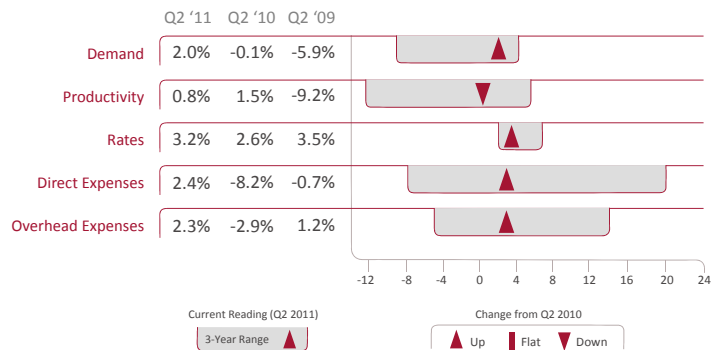
² Demand is defined as the growth in billable hours.

PEER MONITOR ECONOMIC INDEX (PMI)

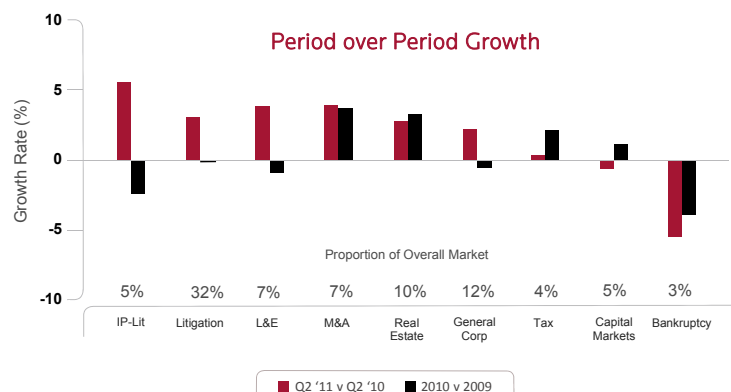


The PMI represents the relative rate of change among the major factors influencing law firm performance. These factors are tracked individually in the graph below.

PMI KEY FACTORS



DEMAND GROWTH BY PRACTICE: ALL SEGMENTS



Am Law second-hundred and midsize firms experienced flatter demand in the second quarter. Firms in these segments, however, continued to increase head count resulting in lower productivity. Midsize firms in particular have been aggressive in adding new lawyers this year, often in excess of what current market demand requires. With demand growth continuing to be positive but tepid, firms need to keep a watchful eye on matching their capacity against available work.

Los Angeles was again the strongest major U.S. market, up more than 5 percent. Los Angeles has steadily gained ground since the trough of the recession two years ago. Chicago was up 3 percent; Washington, D.C. was up about 1 percent; and New York was flat. Demand in London was up 3 percent.

Rates

Rate growth showed a small unexpected gain, with discounted or negotiated rates up 3.2 percent compared with the same period a year earlier. This marks the first uptick in rate growth in over a year. The improvement in rates was largely driven by improvement in rates for litigation, which rose 3 percent. Among market segments, the Am Law second-hundred group of firms was the strongest, raising rates an average of 3.7 percent.

While this is positive news, it remains to be seen whether it represents an improving trend. Rate growth still remains well below historical averages, and it is expected that pricing pressure will persist for the foreseeable future. Going forward, rates will be closely monitored to see whether there is a meaningful break in the pattern of weak rate growth.

Realized rates rose by 2.8 percent, which is significant in that there appears to be some growth in collections following several quarters of largely flat performance. Collected realization was up fractionally, coming in at 87.4 percent. Net collected realization for larger firms is holding at approximately 87 percent while smaller firms appear to have bottomed out at 88 percent. Overall, however, realization levels remain near historic lows.

Expenses³

Costs continued to rise, as both direct and overhead expenses grew. While cost cutting helped sustain profitability through the depths of the economic downturn, it has steadily diminished to the point where firms are now beginning to show cost increases in most categories.

Direct expenses recorded their first increase in more than two years, up 2.4 percent. Firm hiring has been gradually picking up since last summer, and attorney head count has continued to grow throughout 2011. The pace of hiring picked up slightly in the second quarter, with lawyer FTE positions up about 1 percent. The attorney replenishment ratio⁴ continues to be positive for the overall attorney population, as new hires exceed retirements, layoffs and other departures.

Overhead expense growth, which turned positive earlier this year, also continues to accelerate, up 2.3 percent. If this trend continues, the rate of overhead expense growth will overtake direct expense growth later this year.

PMI has been tracking the steady acceleration in expense growth for the last several quarters. Expenses are now on a positive growth curve and will continue to rise for the foreseeable future, if nothing else because of a rebound from the sharp expense reductions enacted during the recession, combined with the inability to further delay certain capital expenses such as technology, and the need to hire lawyers to fill gaps brought on by improving demand. Cost cutting as a means to bolster profitability is no longer available as a strategy for most firms.

³ Includes both direct expenses (salaries, fringe benefits and professional fees associated with billable timekeepers) and overhead expenses (all other nondirect expenses, including staff compensation, marketing, technology, occupancy, office expenses and research).

⁴ Attorney replenishment is the ratio of new attorneys to the firm divided by those departing. A result greater than 1 indicates growing capacity, while a result less than 1 signals a contraction.

⁵ Productivity is defined as hours per attorney and represents the ratio of capacity to market demand.

Productivity⁵

Productivity growth, measured in hours per lawyer, moderated, up only 0.8 percent. While productivity is still improving, it has been dampened by attorney head count increases. Growth in the number of equity partners was largely offset by reductions among associates. Most of the head count increase was accounted for by staff and of counsel attorneys, indicating that firms are trying to be more flexible in managing head count levels against positive but uncertain demand growth.

Continued productivity gains will depend on firms' ability to successfully balance firm capacity against available work, and hiring patterns are likely to remain slightly positive for the remainder of the year.

2011 Outlook

As we move into the second half of the year, the start-stop pace of the economic recovery during the first half creates ongoing uncertainty for the remainder of the year. Demand continues to improve, and for the first time in many quarters, a slight but welcome gust of rate growth is being seen. But whether it marks a meaningful shift in rate growth trends, or is simply a brief, transitory improvement that could quickly dissipate, remains to be seen.

Economists acknowledge that the overall economy recently encountered a "soft patch", and are trimming some estimates for GDP growth for the remainder of 2011 and for 2012. Thus, law firms are preparing for continued uncertainty and are monitoring headwinds and risk factors.

So far this year, improving demand and rates have exceeded cost increases, but this is not likely to continue. As costs continue to rise, top-line growth must accelerate or margins will contract.

In the longer term, firms need to grow fee revenue while adopting leaner, more flexible business models that will allow them to react faster to changing market dynamics. Market conditions have grown more volatile in recent years, and firms must adapt quickly to unexpected developments. As recent events have shown, factors such as geopolitical unrest and global supply chain disruptions from natural disasters can easily unsettle markets and economies worldwide.

While the law firm market continues to show gradual improvement, growth is still well below historical averages, and a myriad of cautionary factors remain in place, including client rate pressures and rising costs. Firms must proceed prudently and closely monitor market trends for signs of changing conditions.

For more information on the PMI, and how Peer Monitor can help your firm successfully manage through today's economy, please contact **Mark Medice at 412-203-2155** (mark.medice@thomsonreuters.com) or visit peermonitor.thomsonreuters.com.

Special Focus: How Do Rates Rate?

For many years, rate growth was the lifeblood of firms. However, the time when rate increases could be reliably counted on to drive firm growth is largely over. While rates were slightly improved in the second quarter, it so far marks only a slight break in the steady decline in rate growth seen over the past several years.

The current market environment calls for firms to be more strategic in how they manage their rates. Across-the-board rate changes no longer work.

There is a widening disparity between firms in their pricing power. Some firms are experiencing strong rate growth by employing well-executed rate strategies, while others languish. A thoughtful analysis of rate performance against relevant peers can provide insights on firm rate performance by practice, especially when segmenting by partners, reviewing rate distribution grids and assessing top-of-market performance.

Firms lacking a strategic focus on rates are largely at the mercy of market forces, subject to client pressures, and diminishing their position in the market, potentially costing millions in reduced profits.

Using Peer Monitor's core analysis, along with the newly offered PLUS database, firms can view broader and deeper rate analysis by timekeepers, practices and geographies than previously possible.

For further discussion on how advanced market analytics can help drive rate strategies, contact your Peer Monitor consultant.

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