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Law firms' survey 2013

Executive summary

Our annual benchmarking survey on law firms

This is the 22nd PwC survey on law firms. The editorial team for 2013 consists of:

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David leads our Law Firms Advisory Group (LFAG). He works closely with and advises national and international law firms on all aspects of their accounting, finance, strategy and business issues.

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We would like to thank all other members of the LFAG who helped with this year's survey, particularly Katie Poole, Fiona Davis, Neil Everstead, Lucy Robson, Mary Marconi, Huw Smith, Keith Orr, John Roberts, Heather Stacey, Joanne Viney, Susannah Mckay and Samantha Kelley, who contributed significantly to the production of this report.

The Law Firms Advisory Group of PwC harnesses the expertise of specialists nationally and internationally to provide assistance with:

- Cost reduction and outsourcing
- Assurance and business advisory services
- Compliance with SRA Accounts Rules and associated regulatory requirements
- Mergers and acquisitions
- Direct and indirect taxation
- Working capital management
- Limited Liability Partnerships (LLPs) and other structuring advice
- Partner reward
- Strategic consultancy
- Employee and employer issues (reward structures and taxation)
- International taxation and accounting
- International restructuring
- International secondments
- Internal audit and other risk management services, e.g. cyber and information securities

Foreword

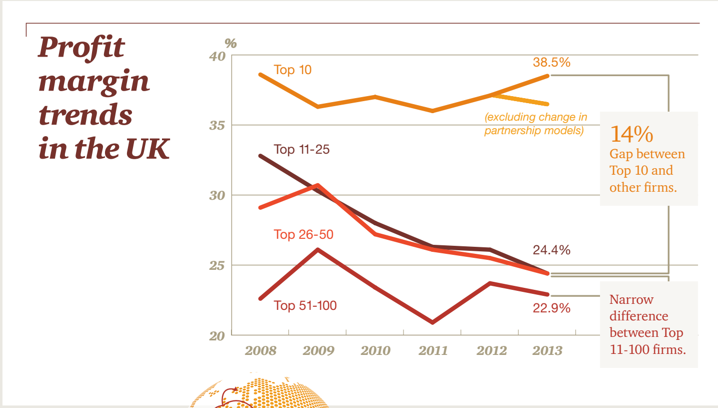
The survey results are presented by size of firm using the bandings Top 10, 11-25, 26-50, 51-100 and outside the Top 100. The classification is by annual global fee income.

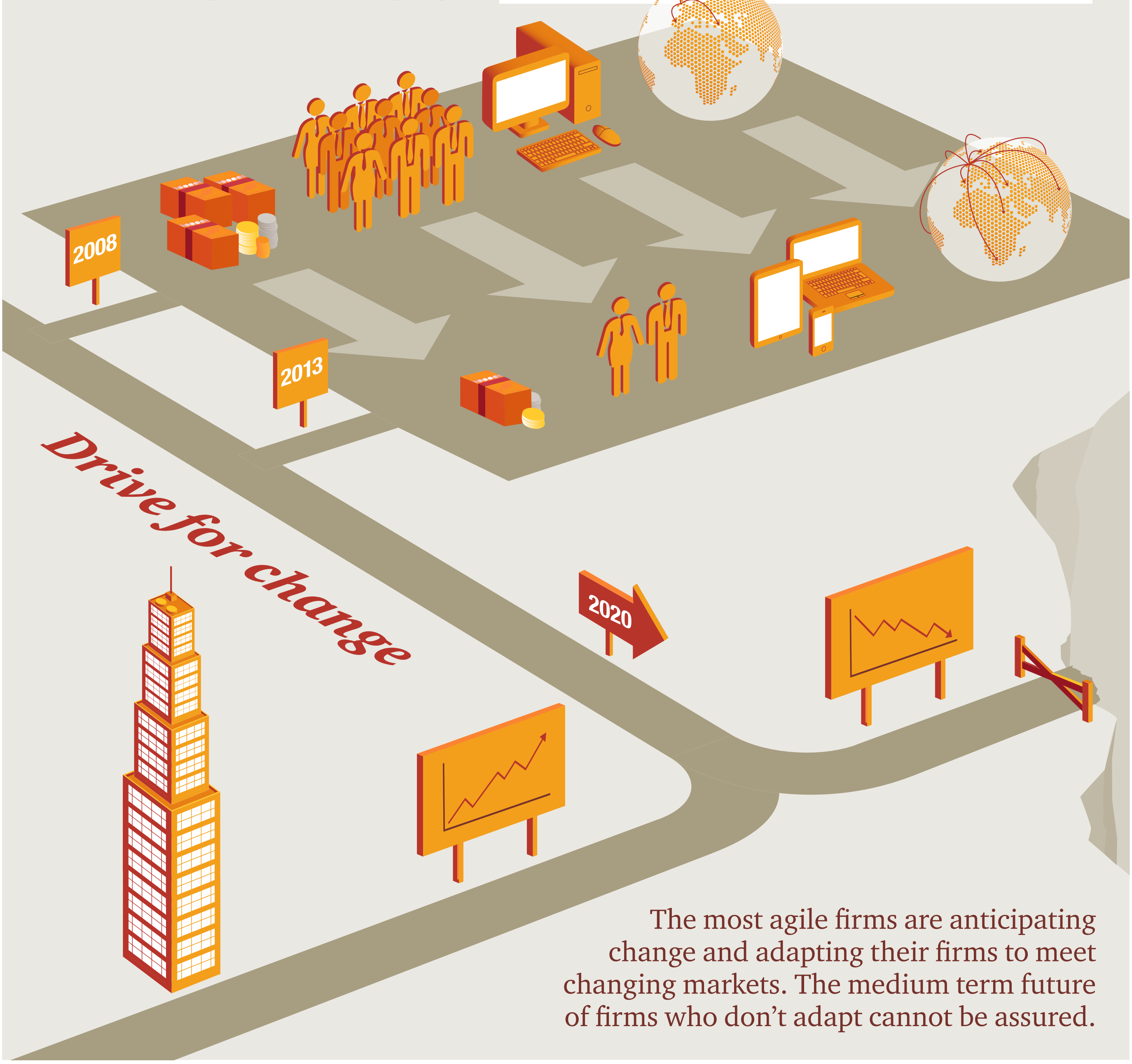
Our report is based on survey responses from the Top 100 firms at consistent response rates to prior years. We have also drawn upon selected information from our quarterly survey and, where relevant, other published financial information.

Our thanks are due, as always, to the firms which participated in this survey. We appreciate that the questionnaire takes a considerable time to complete. All of the responses are processed in full and we have a significant amount of data that is not fully reproduced in this report. If you would like further information in relation to the responses to any of the questions please contact one of our editorial team.

Law Firms’ Survey 2013

Firms will need to find new and innovative ways to deliver legal services if they are to meet the changing demands from clients. Making the best use of technology will be key to future success as will finding more efficient and effective ways of managing their most important asset – people.





The most agile firms are anticipating change and adapting their firms to meet changing markets. The medium term future of firms who don’t adapt cannot be assured.

Introduction and key themes

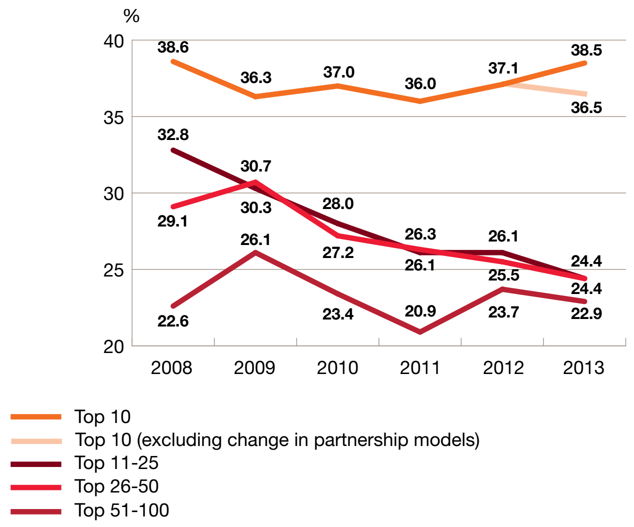
With the global economy now beginning to turn, UK law firms should be well placed to take advantage of an upturn in corporate activity.

While this is undoubtedly true for some firms, the challenges in the UK legal market highlighted in our previous surveys have taken a huge toll on others, so much so that their medium term survival is by no means assured. Pricing pressures, effective utilisation of fee earners and cost reduction have all been major challenges since 2008, driven by shrinking markets, new entrants and consequent over-supply for legal services.

This year's survey represents something of a watershed year. Our traditional segmental analysis of Top 10, Top 11-25, etc., still provides excellent year on year benchmarks; however, merger activity, emerging new entrants, major lateral hiring programmes and restructuring (both at office level and in staffing/partner models) have made it more difficult to identify and interpret trends. This is particularly true in the mid-tier (Top 11-50) which has been most affected by mergers and acquisitions. Accordingly, where appropriate, we have adjusted information to illustrate the impact of these changes.

We also see a much increased market segmentation. Over the last few years we have talked about the clear blue water between the Top 10 firms and the rest of the sector. This has grown to such an extent that average UK net profit margins for the Top 10 are now over 14 percentage points higher than the Top 11-25. In contrast, there is only a 1.5 point difference between the Top 11-25, 26-50 and 51-100 (the narrowest difference our survey has ever recorded). Almost one third of firms outside the Top 10 recorded net profit margins of less than 20% with a number now close to single digit margins. Our view is that unless these firms can radically restructure their business, their short- to medium- term survival must be in doubt.

Trend in UK net profit margins



Profit per equity partner remains the most watched KPI in the sector, and this is another area where the Top 10 significantly outperform the market; Top 10 UK PEP averages £1.0 million after adjusting for changes in partnership models (up 6.1% from 2012). In contrast, average UK PEP within the Top 11-25 was just £448,000 (a fall from the 2012 average of £481,000). There is little difference in the quartile ranges across all size categories of firms outside the Top 10.

The improvement in Top 10 PEP was almost entirely achieved through a focus on cost reduction and tight management of headcount (including equity partner numbers which are down another 1.5% this year). Average UK fee income was up by just 0.8% for Top 10 firms. In contrast, average Top 11-25 firms' fee income rose by almost 9.7%, almost entirely driven through consolidation in this segment of the market. Clearly, this consolidation has yet to translate into improved profitability for these larger combined firms in the mid-tier.

While a number of firms remain UK-focused, many are becoming increasingly international and manage results on a global basis. Increasingly, those firms are seeking to benchmark their performance against international peers, and for this reason we have included this year a section on global financial and operating performance. We have focused on those UK Top 50 firms that generate more than 20% of their revenue from international operations.

Our analysis shows that, at a global level, UK firms have generally found conditions challenging. For the Top 10, global fees per fee earner increased by a modest 1.2% to £341,000 with broadly flat fee earner numbers. Average UK fees per fee earner are some 21% ahead of the international equivalent, with international activities clearly having a dilutive effect on firms' performance as a whole. The dilution is even more pronounced at the profit level, with Top 10 UK profits per partner (in this case all partners to remove any distortions in different partner models) being 52% higher than the average for international offices.

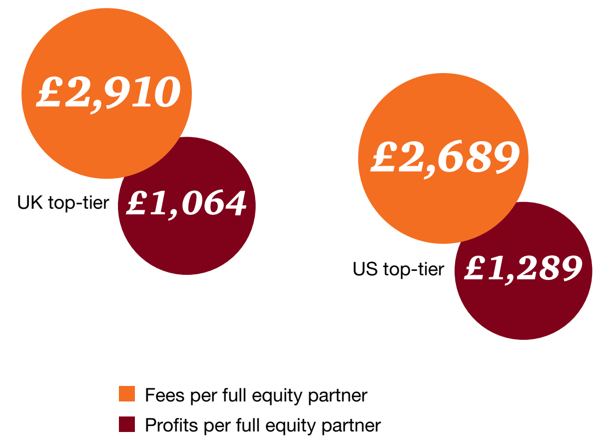
It is clear that many of those firms we have defined as 'global' in the Top 11-50 are struggling to maintain their international networks. During 2013, average global profits per partner have fallen by almost 11%. Average global profits per all partners in the Top 11-50 were just £276,000, with the Top 10 average of £667,000 being 142% ahead of this. We expect many firms in the Top 11-50 will be looking carefully at their international strategies, with a focus on whether there is a sustainable presence in each territory of operation. Office closure, aggressive lateral hiring or merger/acquisition are options that are under active consideration.

We have also looked for the first time at how the UK top tier firms (defined as firms with revenues in excess of £1 billion) compare to their equivalent US counterparts. The US data was obtained with the kind permission of Legal Business and our thanks are due to them.

UK top tier firms compare well in terms of partner leverage, with fees per full equity partner averaging £2.91 million, compared to the US top tier of £2.69 million. However, this doesn't translate into PEP with US PEP of £1.29 million some 21.1% ahead of the UK average of £1.06 million. Fee earner utilisation, premium pricing and the resilience of the US legal market no doubt all play a major part in this differential. Strikingly, if UK Top tier firms were able to achieve the same net profit margins as their US counterparts, a move from a 37% average to 46%, a further £126 million of profit per firm could be generated. This is equivalent, on average, to an additional £295,000 of PEP.

Following a number of well-publicised law firm insolvencies during the year, the legal sector has come under increased scrutiny from the banks and the sector's UK regulator, the SRA (Solicitors' Regulation Authority). Consequently, the

UK top-tier vs US top-tier – Fees and profits per full equity partner



appropriate funding levels for firms, together with effective firm financial management, have risen to the top of the agenda for many managing partners and finance directors. Working capital management lies at the heart of good financial management. Firms can expect their banks to be taking a keen interest in this and seeking reassurance that sound working capital management systems and practices are in place.

This year's survey presents a mixed picture in terms of working capital management. Both the Top 10 and the Top 26-50 have seen some improvement in their lock-up days, but lock up has deteriorated in the Top 11-25. While this is, in part, due to the distorting effect of volume firms, even after adjusting for this, lock-up has increased from 107 to 111 days. Average lock-up throughout the year continues to lag behind year end performance, representing a significant opportunity for firms and an area we expect banks to apply increasing pressure where financing is tight. For a Top 10 firm, achieving our target 110 day total lock-up benchmark throughout the year would potentially release a further £7.6 million in cash on average.

With the onset of the financial crisis in 2008, many firms were careful to restrict their spend in terms of infrastructure (and particularly IT spend). There is now a need for many to reinvest in infrastructure projects (approximately 80% of firms identified their top priority as the need to implement or upgrade IT systems). Capital calls have risen in the Top 10, no doubt partly as a consequence of this need to invest and we expect firms to turn to their banks to assist them with the financing of these projects. Given the heightened scrutiny mentioned above, firms will need to demonstrate a water-tight investment appraisal plan, together with effective and prudent financial management within the firm. The timing of profit distributions may also need to be delayed to fund investment, particularly where lock-up remains below the optimal level.

Effective risk management has moved firmly up the agenda for all firms, following the introduction of the SRA's Outcomes Focused Regulation. Despite this being effective since January 2013, many firms still have an underweight approach to risk, whether through lack of an Audit Committee, under resourced and under-scoped Internal Audit functions or inadequate IT security measures. With Government Communications Headquarters (GCHQ) identifying law firms as a high risk sector, we fear it may take a high-profile IT security breach at a law firm to push the pace of change in one of the most important business issues so far in the 21st century.

As in previous years, we end our survey with some questions around firms' outlook and strategy. Our July 2013 quarterly survey reveals some encouraging signs of pick-up in activity, albeit at modest levels. However, firms remain concerned about continued economic uncertainty and the changing needs and behaviours of clients.

Clients are becoming increasingly sophisticated legal service procurers and more demanding of their law advisors. In response, firms are considering how best to deliver legal services in a way that meets the changing needs of their client base. The biggest global firms will no doubt continue to deliver high value, complex legal services at premium rates, with the significant remainder of the market competing to deliver legal services more efficiently and effectively than their rivals. These rivals are also changing, with new entrants, in particular in the form of corporate/listed entities establishing their own legal practices. These entities may well have established such practices to address their own internal legal needs, but once maturity is achieved, they may seek to expand their service offering to third parties.

Firms are looking at new and innovative ways to deliver legal services, with the use of technology being key (although the ability to finance this investment may well be a limiting factor for some).

Pricing will also be key to future success. Fixed fee pricing structures, standardisation of legal services and 'downshifting' of work to paralegals or less experienced staff will become increasingly common in the battle for the most cost effective delivery of legal services.

Finally, we are beginning to see the emergence of more flexible working arrangements, with firms making use of the temporary employment market to supplement contracted salaried staff. A possible business model for some may comprise a small core headcount of permanent fee earners on traditional employment contracts, supplemented by additional services on demand from a pool of self-employed or zero hours contracted fee earners and partners (who may be alumni of the firm). This moves increasingly towards the concept of the 'virtual firm'.

Looking back, in our view 2013 will be seen as a year that marked a major shift in the legal sector. Big change is clearly well underway, but by no means are we approaching the end-game.

1 Global operating and financial performance

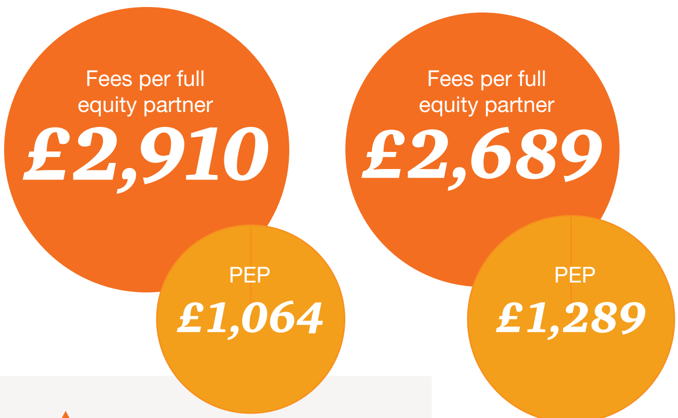
At a glance

- Top 10 firms have consistently improved across each key financial KPI, albeit only to a small degree. In contrast, Top 11-50 have experienced a reduction across all financial KPIs.
- The range of global net profit margins for Top 11-50 firms has widened in the current year, suggesting that certain firms are making the global offering work for them while others are struggling to maintain profitability.
- Among global law firms, UK offices are generally supporting the profitability of their international counterparts; average Top 10 UK profits per fee earner is 52.3% ahead of international.
- Global profits, relative to fee income, for the top-tier of UK-headquartered law firms (being UK-headquartered firms with global revenue over £1bn) still fall considerably short of the leading US firms. For example, top tier UK firms achieve net profit margins of 37% and this is 9 percentage points below the US top tier at 46%. If the UK top tier were to match the US top-tier margins, this would equate to an average of £126m additional net profit per firm.

UK top-tier vs US top-tier

Global fees and profits per full equity partner (£'000s).

UK top-tier *US top-tier*



UK fees per equity partner **8.2%** ahead of US

UK global PEP **17.4%** behind US

UK top-tier do not generate the same level of global profits, relative to global fee income, as the US.

Source: PwC Law Firms Survey 2013

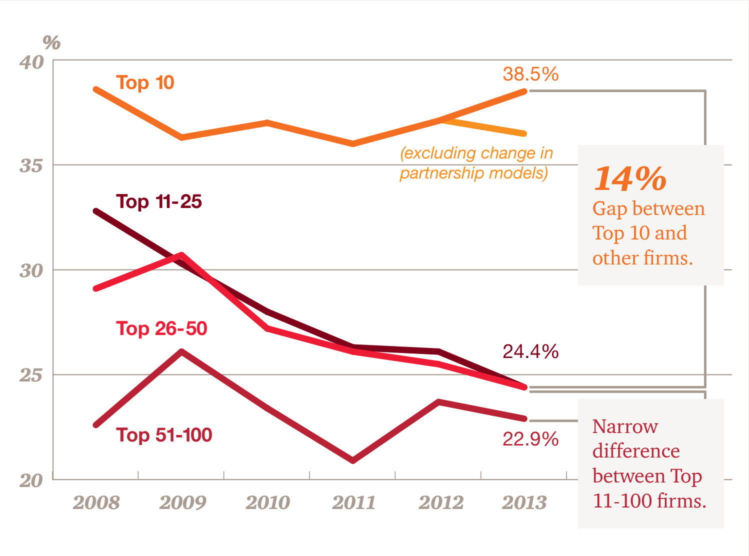
2 UK operating and financial performance

At a glance

- After allowing for inflation and consolidation in the market, UK fee income has remained relatively flat across all bandings, reflecting ongoing pricing pressures and challenging economic conditions.
- Only Top 10 firms, on avarage, succeeded in increasing UK net profit margins; while all bandings outside the Top 10 have recorded another year of declining margins.
- Approximately one third of all firms outside the Top 10 reported UK net profit margins of less than 20%.
- Average UK net profit margins before fixed share equity remuneration for Top 11-25 firms stands at 29.9%, lower than the average for Top 26-50 firms (32.4%) and only 0.3 percentage points ahead of the Top 51-100 firms. This compares with an average net profit margin before fixed share equity partner remuneration for Top 10 firms of 40.7%.
- Top 10 firms' fee income and gross profit per chargeable hour performance has increased (by 11.8% and 11.4% respectively), although gross margin has remained relatively consistent at 71%.
- Top 26-50 firms' fee income and gross profit per chargeable hour has grown above that of the Top 11-25 firms' performance; they are now 11.6% and 10.1% ahead respectively.
- UK fees per fee earner fell for both Top 10 and 11-25 firms, by 3.3% to £353k and 11.3% to £235k respectively. The Top 11-25 firms' performance is at the lowest level since we began monitoring this KPI in 2005. Reduced utilisation is impacting this KPI for the Top 11-25, particularly at the >5 year pqe level. It would also appear that firms have still to fully adjust their headcount down to optimum levels following recent merger activity.
- Top 10 firms' profit per fee earner, at £143k, is approximately 2.5 times greater than the Top 11-25. Top 11-25 firms' average performance now stands at the same level as the Top 26-50 firms (£60k profit per fee earner).

Profit margin trends in the UK

Outside the Top 10, firms are experiencing a continuing decline in margins. The factors affecting the profitability of these firms must be addressed before margins become unsustainable.



Source: PwC Law Firms Survey 2013

3 Business support

At a glance

- Business support continues to be an area of ongoing development and improvement for many firms. Client demands, merger activity and the need to reduce costs are all contributing to the continued need for change.
- In 2013, 60% of Top 10 firms and approximately one-third of the Top 11-100 invested in business improvement and cost reduction programmes. However, most firms do not achieve the scale of benefits that would be expected, the majority of firms implementing programmes saved less than 5% of pre-programme costs.
- Finance and HR are most often regarded as 'a strength' (52% and 35% of responses respectively), while Knowledge Management and IT are most frequently seen as 'a weakness that needs improvement' (23% and 20% respectively).
- Future priorities for Business Support are to 'improve the use of technology' (81% of responses), 'standardise business processes and ways of working' (74%) and 'cost reduction' (56%).
- Within functions, some of the key areas being given attention include:
  - Finance processes to support commercial management of matters;
  - IT solutions that improve fee earners' ability to be more responsive to their clients;
  - HR processes and systems to support talent management and increased international working, particularly in larger firms; and
  - Marketing and BD support for the continued development of sector expertise to differentiate firms in their chosen markets.
- The majority of firms currently use procurement professionals to support less than 20% of annual spend; therefore, there is a good opportunity to reduce costs and improve third-party arrangements.
- Business process outsourcing remains a viable solution for many firms, with areas currently outsourced ranging from IT user support to payroll to reprographics to reception.
- Legal process outsourcing remains in its infancy for the sector, and although the number of firms adopting LPO remains small, there are an increasing number of responses in this category, year-on-year, from firms outside the Top 10.

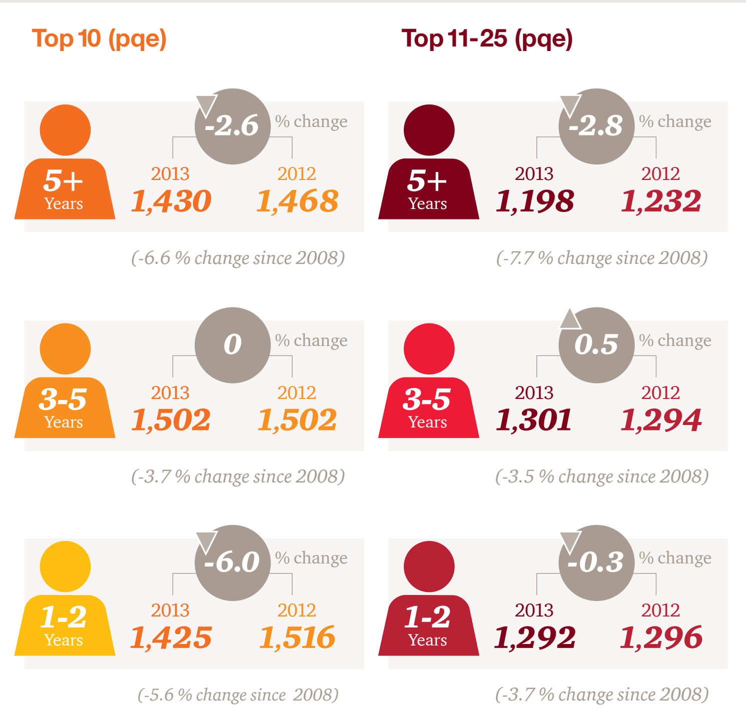
4 People

At a glance

- Total UK headcount has remained relatively static across all bandings, with the exception of Top 11-25 firms where UK headcount has increased by 39.4%. This is primarily driven by merger activity among those firms.
- Chargeable hours have generally fallen across all grades and all bandings of firms. This trend is not sustainable, particularly for firms outside the Top 10 where focus on increasing utilisation must be a priority.
- The grade with highest utilisation in Top 10 firms is newly qualified. While reduction in headcount will impact this, it also appears the 1-5 year pqe grades are pushing work down to the newly qualified grade.
- There is a continuing trend of firms tightly controlling staff costs by minimising increases in salaries.
- The number of non-partner staff in Top 10 and 11-25 firms who have formally set objectives and had a formal performance management discussion has fallen – this may lead to problems in demonstrating fairness and transparency in awarding bonuses.
- Gender diversity in Top 10 firms has become more equally balanced in grades below full equity partner. At full equity partner level though, women account for only 16% of total headcount in Top 10 firms.

Chargeable hours

A number of fee earners in UK law firms are not working to full capacity.



Source: PwC Law Firms Survey 2013

5 Working capital and finance

At a glance

- Law firms continue to apply greater focus to lock-up performance at the financial year end. Across the Top 100 bandings, the difference between year end and average lock-up was between 10.3% (Top 51-100 firms) and 18.6% (Top 10 firms).
- An average Top 10 firm could potentially release £7.6m of working capital through achievement of an 110 day total lock-up benchmark or up to £16.9m through matching the performance of the 1st quartile (100 days).
- UK lock-up performance remains significantly better than international offices.
- There has been an increase in the number of law firms making capital calls on their partners.
- Once the change in partnership models is removed from Top 10 firms, the average capital account balance for a full equity partner has increased by 9.1% to £384k.
- Of all bandings, Top 11-25 firms continue to be most dependent on external finance, with 24% of their finance being sourced externally.

Analysis of law firm funding

The mix of internal funding (through capital and reserves) and external funding has remained broadly consistent. Top 11-25 firms remain the most dependent on external finance, with 24% of their finance sourced externally.

	Top 10 2013	*Top 10* 2012	*Top 11-25* 2013	*Top 11-25* 2012	*Top 26-50* 2013	*Top 26-50* 2012
Partners' fixed capital (%)	39	32	33	34	35	37
Partners' current account (%)	46	54	42	42	46	47
Direct external funding (%)	15	14	24	24	18	15
Other (%)	0	0	1	0	1	1

Source: PwC Law Firms Survey 2013

6 Governance, risk and taxation

At a glance

- Ownership of risk remains fragmented across the sector and is split between the Audit Committee, dedicated Risk Committee and other parties.
- The composition and remit of the Internal Audit (IA) function remains variable. For the 50% of firms who have such a function, approximately one third comprise only one individual and only 28% have more than two. External resource is increasingly being sought to address the growing complexity of the risk agenda including IT.
- Since January 2013, when the SRA's new Outcomes Focused Regulation (OFR) became effective, almost 25% of the Top 100, including 27% of the 11-25 banding, have reported a material breach to the SRA. This has been a stand-alone incident for almost three-quarters of respondees and over half of these breaches relate to the SRA Accounts Rules.
- Focus of the SRA's Client Relationship Manager (CRM) has been one of the new procedures implemented as part of OFR, as well as focus on clients' monies, office monies and anti money laundering procedures.
- Information Security is a key area of focus across all law firms, but over one-quarter of respondees to our survey have yet to carry out a security risk assessment covering both Information Security and Physical Security. The nature and extent of security incidents faced by law firms, coupled with the growing expectations of clients, are key triggers for such activity. For around 40% of the Top 25, reporting in-house Information Security provisions is now a prerequisite as part of many key client pitch processes.

7 Outlook and strategy

At a glance

- The majority of firms remain confident of achieving growth over the next three years, with firms in the Top 25 more optimistic than those outside the Top 25. Despite this, there is still considerable uncertainty regarding the prospects for the legal sector as a whole.
- Approximately half of Top 50 firms believe they will outperform the sector, with virtually all firms seeing 'better penetration of existing markets' as one of the main opportunities for growth. As a result, pricing and margins will remain under pressure and clear winners and losers will emerge.
- Lack of stability in the legal market due to general economic conditions and clients' changing needs/behaviours are seen as the two key threats to business growth, together with over regulation and competition from new entrants to the market. New business models are emerging and firms will need a clear strategy to be able to respond to such challenges.
- International expansion continues to be a strategic priority for many firms including those outside the Top 25. Australia, USA and Africa are the key regions for growth for Top 25 firms, with the Top 26-50 firms seeking to establish presence in the Middle East, China and the Rest of Asia and the Far East.
- 83% of Top 25 firms believe a merger is very or fairly likely by 2016 and this is increasingly likely to be with a non-UK based firm. There appears to be less appetite for merger among Top 26-50 firms, although 42% of these firms still consider a merger to be very or fairly likely.

Contacts

Our law firm specialists provide tax, accounting and business advice to law firms of all sizes. We are always delighted to discuss our thoughts and ideas on current issues and best practice and to explore the opportunities to work with firms throughout the country and internationally. Please contact any of the following if you would like to know more about the particular services offered to law firms by PwC.

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