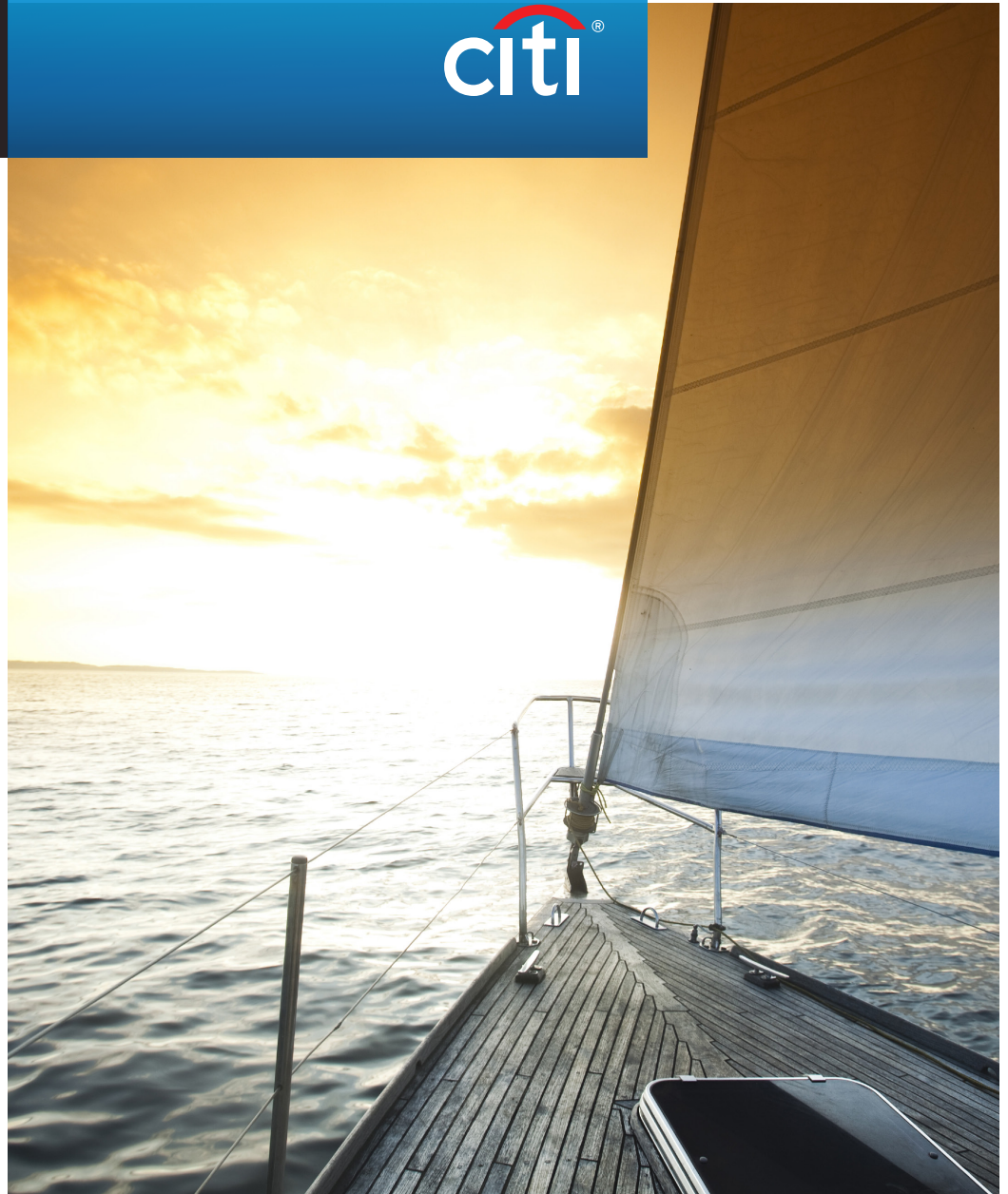


Private Bank



2019 Client Advisory



Executive Summary

The US law firm industry is enjoying its strongest growth in almost a decade.¹ However, dispersion² remains, with the market favoring the industry's largest and, notably, its smallest firms. The concentration of growth within these two market segments indicates that it is reputation and brand that are currently helping firms win new work, rather than scale alone.

Even within the Am Law Second Hundred, which continued to experience pressure in 2018, a group of firms successfully grew demand for their services. Like their larger and smaller counterparts, these firms were also assisted by their differentiated brands.

While dispersion remains a market characteristic, so does market volatility, with a high proportion of firms continuing to experience reverse trends in demand performance from one year to the next.

In this market of strong growth, but underlying dispersion and volatility, the most successful firms will outperform the market by maintaining an approach that is focused on profitable growth and above all else delivering what the client needs. This means following a growth strategy that builds on its market strengths, while protecting the firm's culture. It also means focusing efforts to institutionalize clients in this active lateral market, and the likely increase in partner retirements in coming years. And more than ever before, in the face of evolving technology and the growth of alternative legal service providers in market share, it means becoming more efficient and adaptable in the way a firm delivers legal services.

We expect that 2019 will be another strong year in top line growth for the law firm industry, in the range of 6 to 7 percent. As we also expect increasing expense pressure, we project profit per equity partner growth in the mid-single-digit range. With dispersion expected to remain, further consolidation is likely, particularly where demand and expense pressure are most acutely felt. On the other hand, we expect to see strong outperformance by the firms with the strongest brands.

¹ Our analyses and projections are based on data collected from a sampling of primarily US-headquartered law firms by Citi Private Bank, as well as conversations with law firm leaders. For third-party providers of legal services, our information is mostly anecdotal. Sources include the "Citi Annual Survey Database" of 191 US-headquartered firms, including 45 Am Law 1-50 firms, 33 Am Law 51-100 firms, 45 Am Law Second Hundred firms, and 68 additional firms; the "Citi Flash Survey", including 41 Am Law 1-50 firms, 29 Am Law 51-100 firms, 48 Am Law Second Hundred firms and 49 additional firms; the "Citi Law Firm Leaders Survey" of 55 large firms headquartered in the US, UK, Australia, China and India; and the "Law Firm Leaders Confidence Index" which reports the forward-looking opinions of law firm leaders from 156 firms.

² Dispersion is defined as a near even split between firms that see demand increase and firms that see demand decline year-to-year. Volatility is defined as reverse demand growth trends from one year to the next.

The Legal Market in 2018

US

The US law firm market has seen the strongest set of results on key metrics since before the last recession. Among the law firms we surveyed, revenues grew by an average of 6.3 percent during the first nine months of 2018—a respectable increase on the already impressive growth rate of 3.6 percent achieved during the first nine months of 2017.

In line with historical trends, much of the revenue growth generated in the first nine months of 2018 can be attributed to billing rate growth and, to a lesser extent, demand growth. During this time, billing rates grew by 4.3 percent—the highest result we have published at the nine-month point since 2014, and above the 2010-17 average compound annual growth rate (CAGR) of 3.9 percent. At 2.5 percent, demand growth was also the highest our survey has recorded since 2007. In the past seven years, demand has grown at a CAGR of 1.1 percent.

Firms told us that, unlike the recent past—when transactional work tended to be the primary driver of activity—growth in 2018 was more balanced between transactional and litigation practices. While many firms have scaled back their litigation practices in recent years, it appears that many are reaping the rewards of right sizing, and reporting strong levels of activity. On the transactional side, we continued to hear that private equity remained a strong growth driver.

The only drag on top-line growth through the first nine months of 2018 was that the collection cycle lengthened by 0.8 percent. The resulting build up in inventory—6.6 percent in the case of accounts receivables, and 7.8 percent in the case of unbilled time—suggests that full year 2018 revenue figures are likely to result in even higher growth rates, so long as firms focus on collections.

During the first nine months of 2018, total lawyer headcount grew by 1.6 percent. This headcount increase was driven by salaried lawyer growth—equity partner headcount declined by 0.3 percent. This is a continuation of a seven-year trend, where equity partner numbers have remained essentially flat, while leverage has increased. On a positive note, while headcount continued to grow, average lawyer productivity also grew—up by 0.9 percent at the nine-month point.

Less positively, law firm costs rose by 5.9 percent during this period. These costs were largely driven by rising lawyer headcount, together with mid-year associate salary increases. We anticipate further cost pressures to occur during the remainder of 2018, as another quarter of the mid-year associate salary increases feed into law firms' overall expenses. In addition to salary cost growth, law firms also tell us that technology upgrades, cybersecurity, professional staff, and new real estate investments are expense pressure points.

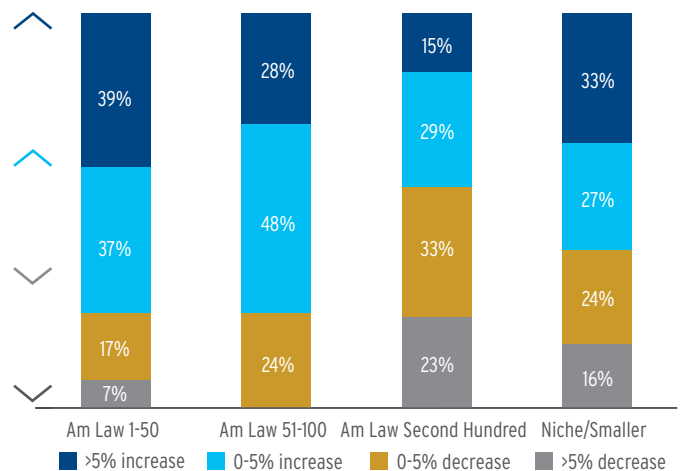
Although our results for the first nine months of 2018 generally paint a positive picture of law firm finances, a more granular analysis suggests this positivity is not evenly spread across the legal market. For several years, we have seen the lion's share of Am Law 200 revenue and profit growth concentrated among the Am Law 50 firms—largely at the expense of the Am Law Second Hundred. This trend of the market favoring the Am Law 50 was particularly pronounced during 2018.

Overall, average demand across the Am Law 50 rose by 3.3 percent during the first nine months of 2018—a noticeably higher rate than any of their smaller peers. In fact, 76 percent of Am Law 50 firms recorded some level of demand growth during the first nine months of 2018. By contrast, the Am Law Second Hundred saw a demand decline of 0.2 percent during this same period.

That said, our research suggests that size is not a reliable indicator of a firm's ability to increase demand for its services. During the first nine months of 2018, niche firms—those which fall outside of the Am Law 200—enjoyed the second strongest set of results of all firms we surveyed. These firms saw demand grow by an average of 2.5 percent during the first nine months of 2018. More than 40 percent of niche practices reported revenue growth of five percent or higher.

Within each market segment, we continued to see dispersion (see Chart 1). While demand fell for the majority of Am Law Second Hundred firms, a select group of firms within this cohort significantly outperformed their direct peers, the Am Law 100, and niche practice rivals: 15 percent of Am Law Second Hundred firms enjoyed a demand growth rate of five percent or more. A further 29 percent of firms in this market segment enjoyed demand growth of up to five percent. Collectively, these findings demonstrate that law firms who enjoy a strong reputation and brand can still increase demand for their services and outperform rival practices of any size.

Chart 1: Demand Dispersion by Market Segment: 9mo '17-'18



Source: Citi Flash Survey

Throughout 2018, the lateral market continued to be very active and, at times, aggressive. As a result, lateral recruitment remained the primary driver of consolidation in the legal industry. Although our research shows that a high proportion of lateral hires do not perform as hoped, we also note that those laterals who have been successful have made major contributions to their new firms.

We have observed several domestic US combinations taking place during 2018, with many mergers occurring between large and small regional firms. Several of these mergers have allowed existing multi-site firms to expand their national reach, while others have seen larger practices acquiring boutiques that have a complementary practice area focus.

Expanding outwards from the US, a small group of very large US-based firms have recently acquired local practices in both Western Europe and South America. And, increasing their (indirect) US market coverage, two of the Big Four accountancy practices have recently formed alliances with immigration-focused law firms that operate in the country.

We anticipate a strong year end for 2018, with top-line growth likely in the 7 to 8 percent range, but also characterized by expense pressure and continued dispersion among and within market segments. We would expect average industry profit per equity partner (PPEP) to likely be in the mid-single digits.

The UK

While Brexit continues to cause political division and economic uncertainty, the UK's leading legal practices have—so far—been almost entirely unaffected by these developments. In the financial year that ended in April 2018, many firms recorded revenue growth of 5 percent or more. Undoubtedly, this revenue growth has been helped by the recent strength of the UK corporate M&A market.

Early indications suggest firms' performance during the first half of the 2018-2019 financial year has remained strong. However, there is more uncertainty during the remainder of this current financial year. This uncertainty is being prompted by a variety of factors, including imminent Brexit deadlines, strains in emerging markets, and the perception that potential UK takeover targets are now fully valued.

One important development is the increasing competition for clients and lawyers between a select group of US firms and UK firms. We have seen a number of high profile lateral moves out of UK firms into US firms. This has caused pressure on traditional lockstep compensation systems in the UK firms, as well as pressure on associate salaries.

In the alternative legal services space, the UK legal market has seen considerable activity. Two law firms have become publicly traded companies during 2018, taking the countrywide total up to five. The accountancy-linked law firms have continued to expand their operations, and the number of conventional law firms operating out of low-cost centers has continued to increase.

Germany

The German legal market enjoyed strong growth during the latest financial reporting period, with eight of the top ten firms by revenue reporting income growth in excess of 10 percent. Revenue per lawyer (RPL), PPEP and practice headcounts were also generally in positive territory, albeit with one or two significant exceptions. Germany's largest firms have maintained a roughly equal balance between indigenous and cross-border practices in recent years. However, the latest financial data suggests that indigenous practices are being particularly successful at growing revenue, while US-headquartered firms are enjoying some of the highest RPL and PPEP increases. That said, it has been difficult for many international firms operating in Germany to achieve a consistent flow of high value work.

Russia

There is currently little interest among foreign firms in opening new offices in Moscow. While foreign firms already present in the Russian capital continue to report a steady flow of work, concerns are being raised in some quarters regarding proposed rules that could adversely affect their future presence in the country. These planned measures include proposals to introduce monopoly practice rights for Russian qualified advocates and law firms, and to ban advocate firms from being directly or indirectly controlled by foreign entities.

China

Strict restrictions on foreign firms' right to practice means that most US firms operating in China (PRC) are not benefitting from the country's rapidly expanding domestic legal market—many domestic PRC firms achieved growth of more than 20 percent during 2017. That said, Citi's 2017 Annual Survey suggests that the profitability of our sample firms' Asian offices has improved.

In the one key location where partnerships between foreign and local PRC law firms are possible—the Shanghai Free Trade Zone (SFTZ)—take up of this freedom has, to date, been slow. 2018 was notable for two new partnerships between Western and local firms. This took the total number of Western/PRC firm partnerships operating in the SFTZ to five.

Hong Kong

The Hong Kong Law Society is currently consulting on proposals that will further restrict the practice rights of lawyers who are not locally qualified. Under one of the Law Society's proposals, out-of-state lawyers will not be permitted to work on Hong Kong Law matters, however informally. Instead, they will only be allowed to advise on the laws of the jurisdictions in which they are qualified. In another planned rule change, local Hong Kong law firms would be obliged to employ two locally qualified lawyers for every one foreign lawyer—currently, the ratio is one to one.

Despite these planned restrictions, we believe that PRC law firms, in particular, are likely to increase their Hong Kong coverage in the next few years. This is likely to change the nature of this legal market, and create more competition with Western firms. Currently, PRC lawyers make up around 220 of approximately 1,600 foreign lawyers registered as working in Hong Kong, and around 30 of the 87 registered foreign law firms.

Singapore

We expect additional law firms to open offices in Singapore in the near future—although perhaps not at the same pace as in recent years. Singapore is widely regarded as being a safe place to do business, and a useful alternative location to do deals, should the PRC put Hong Kong under pressure. Domestically, the Singaporean government is continuing with its campaign to attract new business and diversify its economic base. In the legal sector, this state-supported diversification program includes expanding beyond the jurisdiction's traditional strength in arbitration to also encompass legal services innovation.

Australia

The Australian legal market has performed well in 2018, with demand increasing sharply. A number of factors are helping to keep this market buoyant. These factors include: strong corporate M&A activity, the Hayne Royal Commission into the banking and financial services sector, an improvement in the price of natural resources, and numerous class action law suits.

India

A recent Supreme Court judgment has continued to make life difficult for out-of-state law firms and lawyers. The ruling has confirmed that foreign-owned law firms remain banned from opening offices in the country. It has also clarified the rights of foreign lawyers to advise on foreign law matters during fly-in-fly-out visits. Such visits must be “casual,” the Supreme Court has ruled, rather than a regular occurrence. And, while the Supreme Court has confirmed that foreign lawyers are allowed to appear in international commercial arbitration proceedings held in the country, it has also decided that these foreign lawyers should be obliged to obey ethical rules drafted by the Bar Council of India.

Latin America

An increasing number of foreign firms have shown an interest in opening offices in Latin America. Brazil is currently attracting the highest level of interest, although regulatory restrictions make opening offices in the country complicated. It remains to be seen if the newly elected government will liberalize the Brazilian legal services sector, in addition to its plans to liberalize the financial infrastructure and energy markets. Other countries that are attracting foreign law firm interest are Argentina (although the political situation is challenging), Chile, Peru and Colombia. Mexico is already home to numerous foreign law firms.

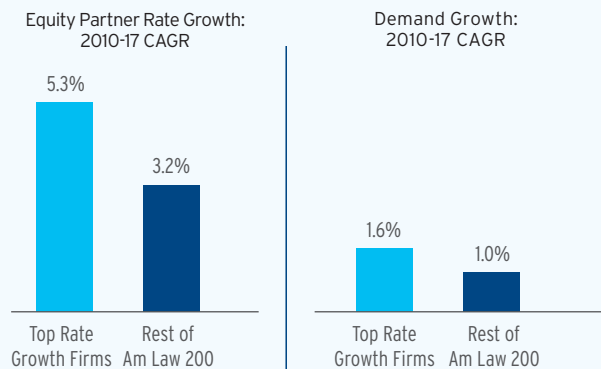
Price Elasticity of Demand

The period of 2010-17 has been defined by modest demand growth for legal services and constant pressure on price by clients. This means that, in order to grow revenues, firms had to increase their standard rates. During this time, the average annual rate increase across all firms we surveyed was 3.9 percent.

If firms increased their rates above this average, did it make them less competitive, and therefore less able to win work? We tested this line of thinking by evaluating the “price elasticity of demand” between 2010 and 2017.

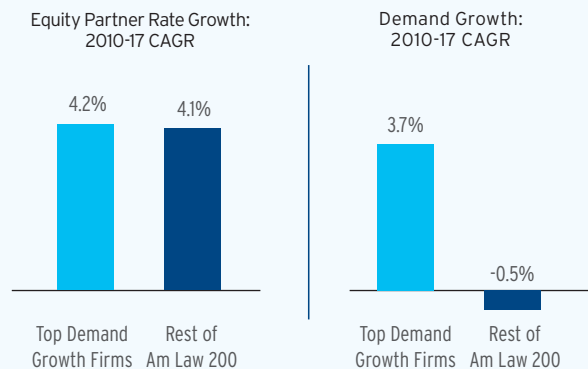
To test the price elasticity of demand, we observed two groups of firms. The first group we called the “Top Rate Growth” firms: these were the top quartile of firms in our Am Law 200 sample who had increased their standard equity partner rates by the highest amount during 2010-17. We called a second group “Top Demand Growth” firms. This quartile enjoyed the highest demand growth of the Am Law 200 during the same period. For our Top Rate Growth firms, we wanted to establish if they had sacrificed demand growth in order to achieve market-beating rate growth. For our Top Demand Growth firms, we wanted to see if they sacrificed on price, or specifically competed on price, in order to capture additional demand relative to the rest of the market.

Chart 2: Price Elasticity of Demand: Top Rate Growth Firms



Source: Citi Annual Survey Database

Chart 3: Price Elasticity of Demand: Top Demand Growth Firms



Source: Citi Annual Survey Database

We found that Top Rate Growth firms grew their standard equity partner billing rates by an average of 5.3 percent each year—a far higher pace than the remainder of the Am Law 200, where the annual rate increase was just 3.2 percent (see Chart 2). This 2+ percent difference in these firms’ approach to rates was material, especially when compounded over the entire seven-year period of our evaluation. Despite this significant uplift in their standard rates during this time, the Top Rate Growth firms showed no signs of sacrificing demand growth. In fact, those firms enjoyed an average demand growth rate of 1.6 percent, compared with just 1 percent for the rest of the Am Law 200. This suggests there were more important considerations for clients, beyond price, when deciding to use the services of Top Rate Growth firms.

We also found that Top Demand Growth firms enjoyed an average annual growth in demand of 3.7 percent during 2010-17 (see Chart 3). By contrast, the rest of the Am Law 200 saw demand decline 0.5 percent each year during the same period. However, we did not find evidence to suggest that Top Demand Growth firms were winning new work by competing on fees. Both these firms, and the remainder of the Am Law 200, grew their standard equity partner billing rates by just over 4 percent during this time. Once again, this suggests that the Top Demand Growth firms were winning work based on factors other than price.

In both cases, we did not find evidence that a firm’s approach to standard rate growth during 2010-17 affected its ability to capture demand. What we did find, however, was a correlation between the willingness of a firm to accept a discount from its standard rates. Both Top Rate Growth firms and Top Demand Growth firms saw greater declines in realization than the remainder of the Am Law 200 during 2010-17. In our discussions with these firms, we discovered that this willingness to discount was often the result of formal pricing processes and/or committees, which centralized the decision making around this issue. Having a formal process in place, it seems, means that firms are often more willing to offer steeper discounts where there is a strong business case to do so. This formalized approach can also help prevent the occurrence of unnecessary or unprofitable discounting.

Despite past predictions that law firms would not be able to raise rates, our analysis demonstrated that firms did not sacrifice work as they increased their rates. Nor did the firms who saw the greatest growth in demand achieve this through slowing down rate increases. Rather, demand growth was determined more so by brand than by price. In our view, brand strength and product focus are among the most highly rewarded traits of a law firm in today’s market. In recent years, much of the demand growth has come from high value work—work that is typically undertaken by firms who enjoy a strong brand, and can command high rates. Firms who have established themselves as the go-to practice in a market—whether that be by industry, practice or region—have been able to increase demand for their services while also charging higher rates.

The Legal Market in 2019 and Beyond

Much like 2018, Citi expects 2019 to be characterized by positive and synchronized economic growth across regions. Policy and trade uncertainty is likely to weigh on markets and corporate profit growth. But low inflation, healthy financial conditions, and gradual rate increases by the Fed suggest we are not yet at a turning point in the business cycle. Should market volatility abate, the stage is set for a pickup in IPO volumes. Much will depend on the success of high-profile technology IPOs planned for 2019. On the M&A front, a combination of factors may drive another robust year for global deal activity. These include increasing cross-sector deals, strong corporate earnings, more reasonable valuations, and high cash on hand for both sponsors and corporates.

We expect that 2019 will be another strong year in top line growth for the law firm industry, in the range of 6-7 percent. That said, we also anticipate continued dispersion and ongoing expense pressure. We therefore project PPEP growth in the mid-single-digit range.

Respondents to Citi's 2018 Law Firm Leaders Survey told us that growth will come from continuing to build scale and focusing on cross-selling efforts. In particular, firms tell us that they are focusing their investment in high-growth and high-profit practices, while looking to scale back unprofitable practices. To achieve growth, they are attracting talent and work by emphasizing their recent strong financial performance. However, law firm leaders also acknowledge that, just as they are looking to attract top talent and clients from rival practices, so too are their competitors.

As part of their commitment to "approaching our work from the mindset of the client and the challenges they face," several firms observed that their focus continues to shift from

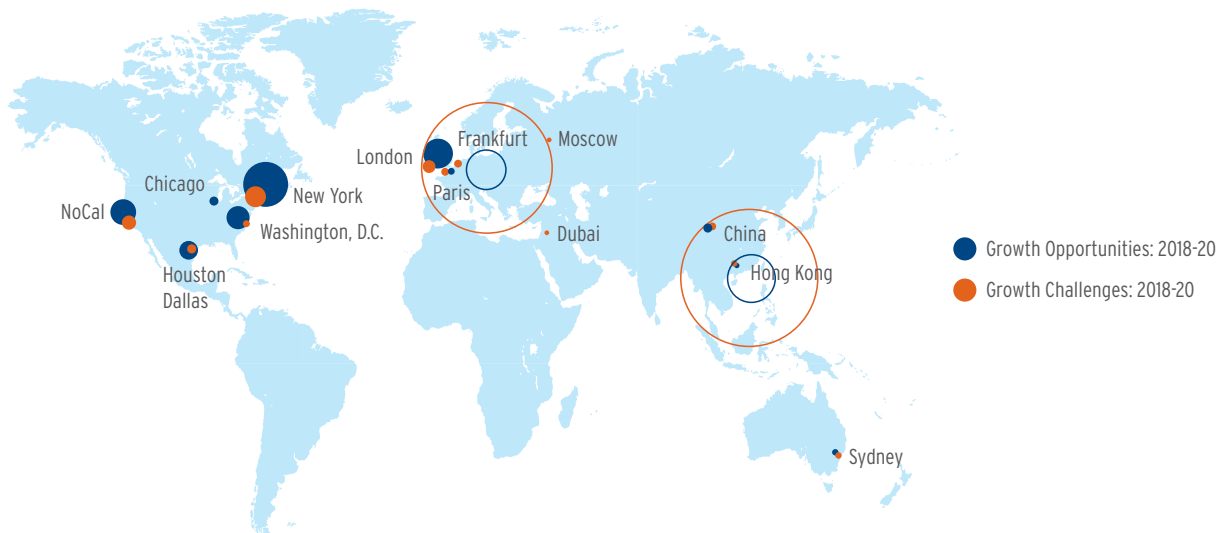
operating on a practice area basis to one based on industries and markets. We believe this is a sensible strategy: over many years, we have observed that law firms who primarily promote themselves by reference to their industry sector expertise tend to outperform those who promote themselves on a practice area basis. There are two obvious reasons for this. Firstly, a sector-focused organization structure is inherently more client-focused. Secondly, it also makes it easier for firms to cross-sell.

Where will growth come from?

Geographic growth opportunities. In Citi's 2018 Law Firm Leaders Survey (see Chart 4), respondents once again singled out New York as the strongest opportunity over the next two years, followed by London—although many cite the challenges of attracting talent and work in these two highly competitive markets. With regards to London, there remain concerns regarding the impact of Brexit. Outside of London and New York, firms also highlighted Washington DC, Northern California, Houston and Dallas as growth markets, given that regulatory, technology and energy-related work are likely to be drivers of growth. For some, Chicago is also viewed as a growth market.

Elsewhere in the world, leaders of what are predominantly US and UK headquartered firms largely viewed Europe and Asia as being challenged, though with some expressing optimism, specifically mentioning Paris, China and Hong Kong. That said, where Dubai and Moscow were mentioned, it was solely in negative terms. We would also note that, while Germany saw positive news for many foreign firms in 2018, looking forward, some view Frankfurt as challenged in the next two years.

Chart 4: Growth Opportunities and Challenges by Region: Through 2020



Source: Citi Law Firm Leaders Survey

Practice area growth opportunities. Law firm leaders identified M&A/transactional work as the primary driver, closely followed by general litigation and financial/capital markets work. While many named general litigation as a huge growth area, a large number also regarded this practice as having its challenges over the next two years.

Other practices likely to drive growth include white collar/regulatory investigations, intellectual property and real estate. On the other hand, labor and employment, patent litigation and, surprisingly, bankruptcy/restructuring were regarded as the practice areas most likely to be challenged in the next two years.

Industry growth opportunities. Law firm leaders viewed technology as the primary driver of growth through 2020, followed closely by life sciences, health care and pharmaceuticals. Firms also remain optimistic about the private equity, energy and real estate sectors. Of all market sectors, respondents' attitudes towards the financial sector was the most uncertain: while many thought it offered a significant opportunity for growth, many others regarded it as challenging. This negativity is likely to be caused by the disintermediation of European banks, as well as the pricing pressure and data privacy restrictions placed on firms.

Growth through consolidation. With market dispersion likely to continue, we anticipate further consolidation. While there are rumors of large firm mergers, we will continue to closely watch acquisitions and mergers—especially those involving Second Hundred firms. We also expect that growth through lateral acquisitions will continue at high levels.

In any merger situation, the key outcome should be the successful integration of the firms' legacy practices. However, in our experience, we find that many personnel involved in law firm mergers significantly underestimate the complexities of this integration process. A successful integration is typically far harder to deliver than the merger agreement which precedes it. That said, when a merger is successful, the resulting practice is typically greater than the sum of its parts. The combined firm should be able to attract better clients, work and talent, in light of its improved market proposition, while also delivering internal efficiency improvements.

While revenue growth is key, in a rising cost environment, firms will also be focused on expense management. Pressure on salaries as headcount increases and shortages continue among mid to senior level associates, technology upgrades, cybersecurity investments and end-of-lease-cycle decisions on whether to move or refurbish will all place pressure on margins.

In our view, perhaps the single biggest expense management opportunity for law firms is to analyze the profitability of every segment of their leverage model, and decide whether the current composition of that leverage model makes sense from a profitability standpoint. Indeed, while we do not anticipate a recession in 2019, when the inevitable downturn

does occur, we expect that law firms will realign both their legal and administrative staff to meet lower demand levels. In making decisions around rightsizing lawyer leverage at that time, studying the profitability of each category of leverage would be a worthwhile exercise. That said, experience tells us that law firms are typically quick to recover from economic downturns, so long as their internal fundamentals are sound.

How will the delivery of legal services change?

Given the challenges firms will face in a market where competition is likely to remain fierce, pricing pressure will remain and costs are likely to rise, firms are likely to make changes to their business model to focus on growth and efficiency. As mentioned earlier, in addition to investing more in the practices that they are best known for, and that deliver the greatest profits, they tell us that they are addressing underperforming practices and offices. Driven to become more efficient, they tell us that they will introduce more alternatives to traditional leverage and look to use more technology (especially artificial intelligence). Above all else, many have told us that the biggest changes to their business models will be a shift in how they approach the delivery of legal services based even more from the mindset of the client, solving their complex business issues within defined budgets, using alternative pricing, project management and emerging technologies.

More alternative fee arrangements

Respondents to Citi's 2018 Law Firm Leaders Survey suggest the shift towards alternative fee arrangements (AFAs) is ongoing—and growing at a faster pace than survey respondents had previously anticipated. In 2017, survey respondents had expected AFAs to account for 15.9 percent of firm revenue: in fact, the percentage that year was 18.7. Overall projections for 2018 suggest this percentage is likely to surpass 19 percent—another record high.

To date, not all firms we surveyed have embraced the shift towards AFAs. Indeed, around a third of all law firm leaders who responded to our survey said that AFA-based billing currently accounted for less than 10 percent of firm revenues. On the other hand, almost one third of respondents reported that AFA usage has now exceeded 20 percent of their firm's revenue.

Looking forward, law firm leaders tend to believe the shift towards AFAs will continue. In total, some 87 percent predicted that usage of AFAs would increase by 2020, compared with 13 percent who anticipated that usage would remain at current levels. Tellingly, none of our survey respondents anticipated a fall in AFA usage by that time.

Although AFA usage has increased in recent years, a majority of survey respondents have not yet seen them have a positive impact, either in terms of realization or margins. For those who reported AFAs as improving profitability, several reasons were noted—including that they could now beat hourly rates where proper scoping, staffing, pricing and reporting work

was undertaken. Some respondents also stated a belief that usage of AFAs could lead to the firm attracting more work, because clients liked the transparency and predictability that AFAs bring to the relationship.

Survey respondents were more optimistic about the profitability of AFAs by 2020. Two key explanations were offered to explain this emerging positivity: firstly, it was felt that a greater experience of using them would ultimately yield better outcomes. Secondly, greater usage of AFAs would allow the effects of specific bad outcomes to be diluted.

One possible reason why take-up of AFAs is not higher is that, while many clients initially ask for work to be undertaken on an AFA basis, they ultimately request a discounted hourly rate instead. This is an outcome which law firms tell us occurs on a regular basis. AFAs, it seems, are not always as popular among clients as discussions in the legal press and conference circuit suggest they might be. Ultimately, many clients simply want firms to deliver legal services at a lower cost than before.

More focus on pricing and project management

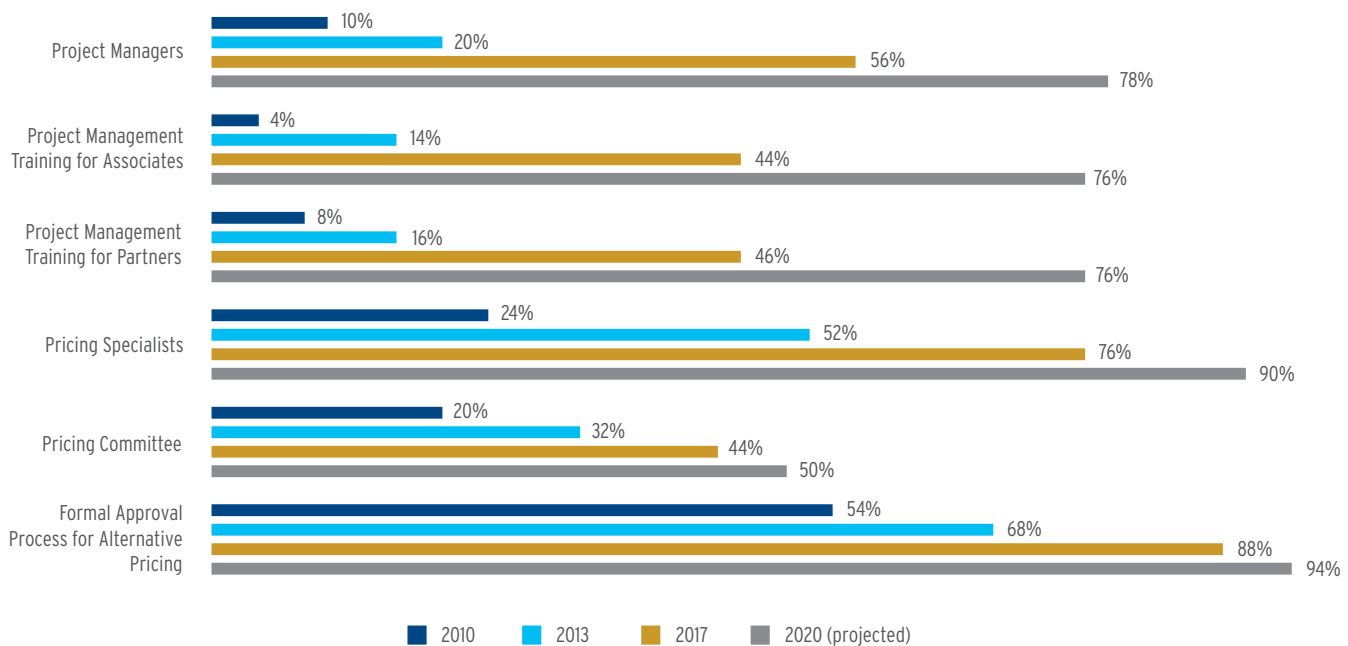
Besides new investment in legal technology, surveyed law firm leaders indicated a strong—and increasing—commitment to project and pricing initiatives. Just over three quarters of firms said they planned to employ project managers in the

near future: by way of comparison, this percentage was 56 percent as recently as 2017 (see Chart 5). In a similar vein, in excess of three quarters of respondents said they intended to offer project management training to both associates and partners: in 2017, less than half said they did so. The growing enthusiasm for project managers represents a remarkable cultural change—until comparatively recently, barely a quarter of firms we surveyed employed any project managers whatsoever.

A similar increase can also be observed in relation to how firms price matters. Pricing specialists are a relatively recent addition to many law firms’ payrolls. Yet by 2017, more than 75 percent of survey respondents tell us they had pricing specialists. By 2020, this number is projected to increase still further, to more than 90 percent of respondent firms. An even greater percentage of firms we surveyed said they intended to adopt a formal approval process for alternative pricing.

Collectively, law firms’ project management and pricing efforts appear to be paying off: the vast majority of law firms we surveyed reported that both initiatives have had a positive impact on both realization and margins.

Chart 5: Pricing and Project Management Initiatives: 2010-20



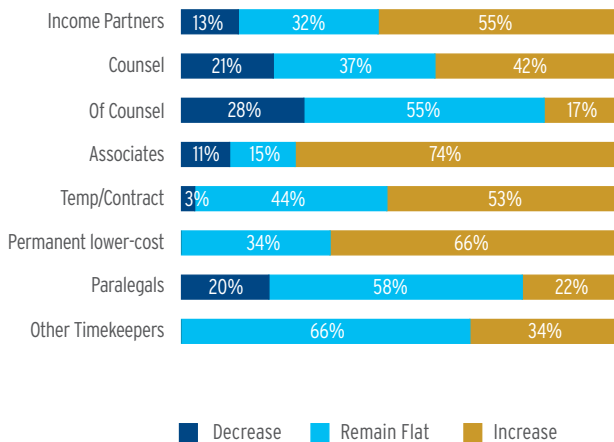
Source: Citi Law Firm Leaders Survey

Changes to the leverage model

Immediately after the last recession, law firms moved away from associates in their leverage model. But, more recently, we have seen firms recommitting to them. This renewed commitment is reflected in Citi’s 2018 Law Firm Leaders Survey, which found that three quarters of survey respondents expected to increase their associate numbers in the period up to 2020 (see Chart 6). By contrast, barely one in ten survey respondents said they intended to cut their associate numbers within this timeframe. There was less consensus regarding firms’ plans in relation to future income partners and counsel hiring. Historically, associates have tended to be more productive, when compared with their more senior counterparts. In many cases, associates are also more profitable.

In relation to alternative resourcing options, surveyed firms signaled their ongoing enthusiasm for a variety of non-traditional roles. Through 2020, a majority of firms said they planned to increase their usage of temporary/contract personnel. An even larger percentage—two-thirds—said they would increase their usage of permanent low-cost employees. For others, they are more likely to keep steady levels of these lower-cost lawyers than actively decrease them. The shift toward more lower-cost lawyers suggests that firms are actively focused on ways to deliver legal services as efficiently as possible.

Chart 6: Projected Leverage Growth By Category: 2017-20



Source: Citi Law Firm Leaders Survey

We would also note, that beyond lawyer leverage, firms have grown the number of timekeepers who are not lawyers. These fee earners include patent attorneys, eDiscovery professionals, law clerks, trainee lawyers and project managers. Over the next two years, most law firms we surveyed said they intended to keep their “other timekeeper” headcount broadly static. Firms do not, however, anticipate reducing their dependence on these professionals.

Changes to the desired skills and characteristics of associates

The skills and attributes expected of today’s associates continue to evolve. Over the past few years, those desired skills and attributes have evolved beyond strong technical skills to also include the need to be commercially minded, out-of-the-box thinkers, with a global outlook and sound project management skills. Going forward, these skills will remain in high demand. Increasingly, law firms tell us they are now also seeking candidates who are entrepreneurial and commercially savvy, and able to integrate technology into the delivery of legal services.

One, less welcome, development that firms are now grappling with is that a significant proportion of associates do not want to become equity partners. Instead, many would rather gain a wide range of experiences, and pursue an array of different career alternatives available to them.

The irony is that, for those associates with the skills, expertise and determination to become equity partners, the possibility of achieving that goal is likely to increase over the next few years. As we explore further in this report, the legal sector is now facing an acceleration in the pace of equity partner retirements. These senior lawyers will soon need replacing, and in ever-increasing numbers.

Trends in the Equity Partnership

Equity partner turnover

Throughout the post-recession years, we have reported how firms have closely managed their equity partner headcounts. During this time, additions have roughly equaled reductions (see Chart 7). 2017, however, was significant for two reasons. Firstly, turnover of equity partners—the combination of both additions and reductions—was the highest in five years. Secondly, and for the first time, laterals outpaced promotions.

Last year's preference for lateral hires over internal promotions could very well represent a fundamental shift in how firms plan to drive revenue growth in the years ahead. Based on law firm leader projections, laterals will marginally exceed promotions again in 2018. Beyond this year, they project that laterals will, at the very least, remain on equal footing with promotions. In any case, we believe that it is unlikely that there will be an imminent return to law firms clearly favoring promotions.

The increased preference for laterals has occurred even though managing partners continue to report less success with their lateral hires than with internal promotions. Our sense is that, for many firms, different criteria are used to define success for laterals vs. promotions. While the criteria of success in relation to promotions tends to focus on "potential," for laterals it tends to focus on "quick delivery"—to generate new revenues, fill in a strategic gap, and bring across clients, if that is what they have promised. Perhaps the reason why the lateral rate of success is so much lower than for promotions, is that the expectations are so much higher, and easier to measure.

Changes to the desired skills and characteristics of equity partners

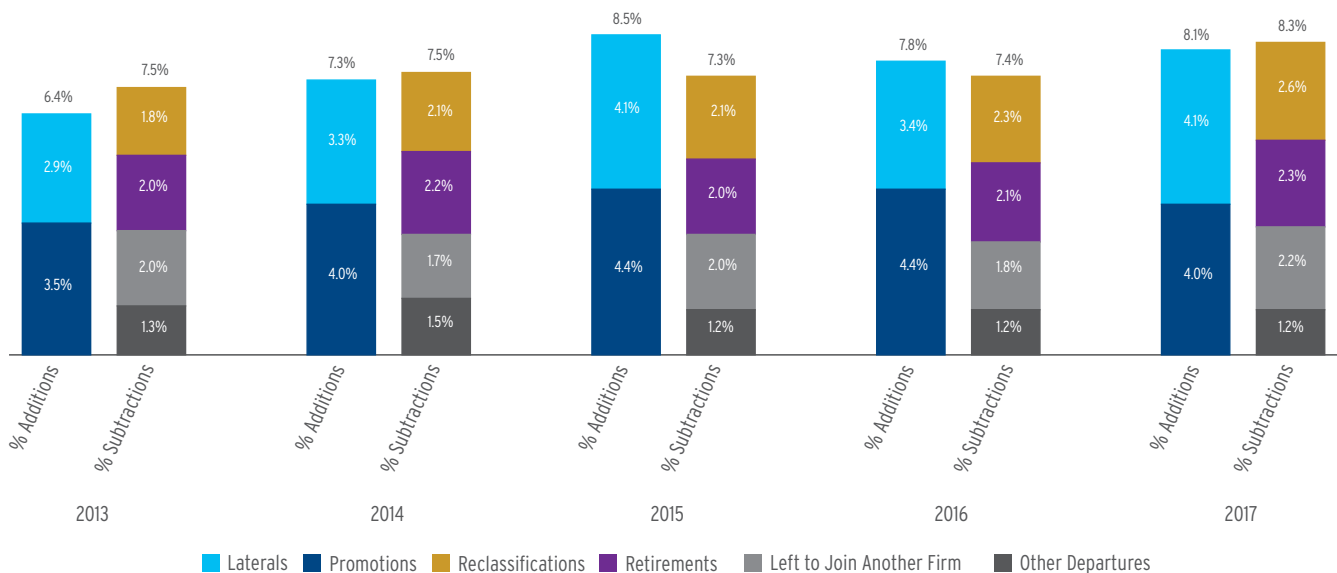
In terms of what defines a successful equity partner, law firm leaders tell us that some criteria will remain constant over the next few years: the need to have outstanding legal skills, to have a strong work ethic, and to be a team player. However, we also notice a subtle shift in the importance of simply generating business and building client relationships toward doing so in a way that benefits the entire firm, rather than just the partner's own practice. This shift reflects the recognition that some of the greatest revenue opportunities are likely to come from cross-selling existing clients. Firms also told us that they plan to continue their focus on improving diversity within their partnerships.

More equity partner retirements

As noted earlier, turnover of equity partners in 2017—the combination of additions and reductions—was the highest in five years. The number of 2017 reductions alone was the highest we saw during that period. During those five years, the most common reason for a reduction in the equity partnership was de-equitization, with internal reclassifications typically to income partner or of counsel. However, firms anticipated that retirements would overtake de-equitizations in 2018. This is an issue we have been alert to for some time and discussed in the 2018 Citi Hildebrandt Client Advisory.

One explanation for the growing prevalence of equity partner retirements is the existence of policies designed to encourage—or force—this issue. Almost two-thirds of all firms we surveyed had either a mandatory, or early, retirement program in place—or both. Over half the firms we surveyed

Chart 7: Equity Partner Turnover: 2013-17



Source: Citi Law Firm Leaders Survey

had a mandatory retirement policy in place. And, among these firms, the average mandatory retirement age was 67. In terms of voluntary retirement, almost one-third of firms have an early retirement program in place, with eligibility starting as early as 55.

In light of the ongoing reduction in equity partner numbers, we believe that law firms now have an opportunity to demonstrate to their associates that the path to equity partnership remains an achievable and desirable destination. In our discussions with firms, we have seen many examples of practices who invest in talent development, and actively help their associates to overcome roadblocks in their career progression. In our view, there is a very sound commercial justification for this type of investment: given the increasing number of equity partner retirements that are now taking place, firms need to ensure that these senior lawyers can be replaced.

Separately, failing to address the issue of underperforming partners may help preserve firm cohesion in the short-term. But, over a longer timescale, it can be very damaging for the firm's viability. Depressed PPEP figures can make it more difficult to recruit new talent, while also increasing the risk that the firm's star billers will be headhunted by rival practices.

Greater focus on equity partner succession planning

The increased pace of equity partner retirements means that firms are now having to transition an ever-increasing number of client relationships. This transition period is the point in time when clients are particularly susceptible to overtures from other law firms.

Law firm leaders tell us that, if there is one lesson they have learned about client transitioning, it is that it always takes longer than expected. For this reason, the process of transitioning should start early—far before a partner's anticipated retirement date. Clarity and transparency about why the transitioning is occurring is also critical, as is the involvement of firm management. Ultimately, whether a client remains with the firm following a partner retirement is their decision. But, the more that a firm engages with their client before a partner retires, the more likely it is that the client will remain with the firm after the partner's retirement date.

In the main, partners recognize that they owe it to their fellow partners to transition their clients in a timely and disciplined fashion—a successful transition also forms part of their legacy within the firm. But, in order to encourage good behavior, many firms also incentivize this transitioning to occur. Some firms make the transition process a part of a partner's annual review or, more broadly, through their practice group assessment. Financial incentives can also help. Some firms directly tie their partners' retirement benefits to the successful transition of their former clients.

Avoiding a Future Capital Shortfall

Equity partners provide a firm with its working capital, allowing it to function on a day-to-day basis. The retirement of an equity partner therefore has financial consequences for the firm. Unfortunately, our research suggests that the historical trend of tightening law firms' equity pool may begin to have adverse financial consequences for some firms within the next decade.

Our most recent research suggests that, among the firms we surveyed, around 35 percent of a firm's equity partners are aged between 55 and 69, and therefore at—or approaching—retirement age. Collectively, these individuals hold around 45 percent of their firms' permanent paid in capital. This means that such firms are, theoretically, already at moderate financial risk, should a large number of equity partners exercise their rights to early retirement.

Crucially, this risk is not static—instead, it is increasing. If no changes are made to the partnerships of these firms, then by 2027, around 61 percent of these equity partners will be at or approaching retirement age. In terms of permanent paid in capital held by these individuals, this would equate to around 64 percent of the total.

As a result of this demographic change, our research projects that a significant paid in capital gap will have emerged by the year 2027. In order to rectify this shortfall, this group of firms would need to add significant numbers of junior and lateral partners over the next ten years—and their related capital contributions. The timing of capital inflows/outflows can exacerbate this risk for some firms. Firms who allow capital to be paid in slowly—perhaps through holdbacks of partner draws—may have more difficulty filling the shortfall, even if adjustments are made to capital requirements. Similarly, firms who return capital to exiting partners quickly may be at greater risk of facing a shortfall in the first place. Firms who both accumulate capital slowly and return capital quickly are particularly vulnerable.

In order to avoid a future capital shortfall, we recommend that any firm at risk can enhance their equity capital position by undertaking one of the following five capital raising strategies:

1. Firms can retain a proportion of their annual earnings. A retention of up to 10 percent is considered acceptable among many of the largest law firms.
2. Firms can call a percentage of budgeted compensation, timed to the annual distribution. Many high-performing firms have increased their target partner capital to around 25-35 percent of annual earnings.
3. Firms can retain a proportion of contingent revenue. This approach has the advantage of avoiding the need to call partners for capital.
4. Firms can make episodic capital calls. This approach may be challenging for partners, however, if it occurs at a time that is difficult for them.
5. Firms can invite partners to make voluntary capital contributions. A common incentive for this approach is to offer above-market interest rates on the cash retained.

Which capital raising option is most appropriate will depend on a multitude of factors, including firm-specific factors such as the age of the firm's most significant capital contributors and wider considerations such as the state of the economy. However, pursuing at least one of these approaches should help firms substantially mitigate against the risk of a future capital shortfall, where the firm's equity partner demographics suggests that the risk of such an event is real.

Institutionalizing Clients and Building a Strong and Sustainable Culture

In the face of fierce competition for talent and clients, law firm leaders are focusing more than ever before on how to institutionalize clients and build a strong and sustainable culture.

The low rate of lateral success we have often written about has been attributed to the challenges in separating how much a client valued the partner departing a firm vs. that firm's platform. It is often the case that the client valued both and chose to stay with the law firm after the partner left. This suggests that any firm has an opportunity to retain clients in the wake of a lateral loss if they have built strong institutional relationships with their clients.

Law firm leaders tell us that, beyond traditional client service partners, they are creating multiple touch points with their clients across practices and regions. Among the

best practices we've observed, some emphasize the value of creating strong relationships across generations—from associates through to the most senior partners. Others talk of the relationships they are building across different functions in the firm and the client. An example would be the executive director developing a strong relationship with the head of legal operations at a corporate law department client. Another would be law firm pricing specialists collaborating with client procurement teams on fee arrangements.

While formal and structured client feedback programs have existed for a long time, firms also tell us that holding events for clients enables firms to create multiple informal touch points throughout the year.

Rigor around rewarding sharing of clients and work among partners is also key. While the few firms that operate a lockstep or modified lockstep compensation model naturally reward collaboration, we also see performance-based compensation models giving fee credit for cross-selling.

Conclusion

Building on the strong industry performance seen in 2018, we are optimistic about 2019, expecting further strong revenue growth. We also anticipate that market dispersion is likely to continue. As such, we expect further and perhaps accelerated consolidation, particularly involving Am Law Second Hundred firms. We also expect that the market will continue to favor firms with strong brands regardless of their size.

As our price elasticity of demand analysis suggests, clients remain willing to pay higher rates for the legal services they regard as the most valuable they receive. It is therefore vital that firms are able to differentiate themselves from their competitors, and offer a superior proposition in whatever market they trade in.

In a market where lateral activity is likely to remain aggressive, and partner retirements are set to accelerate, firms' efforts to do whatever they can to institutionalize client relationships and strengthen their unique cultures will be important tactics to retain both clients and talent.

As we have observed throughout this report, success is most likely to come to firms who build on their strengths, while being as flexible, creative and efficient as they can be in how they deliver legal services to their clients.

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