Private Bank

2021 Client Advisory

HILDEBRANDT CONSULTING LLC

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Executive Summary

The year 2020 has turned out to be an extraordinarily complex one for the legal profession in the wake of the COVID-19 global pandemic. While the pandemic created unexpected challenges for the legal industry, we also saw better performance than anticipated, and substantially so for some firms.[1] This is in large part due to the strong start to 2020, the way firms adapted so quickly and effectively to a fully remote working environment, and the robust performance of certain practice areas. This latter factor is an important feature of the legal industry—even during economic downturns, businesses still need legal advice.

While the final results in 2020 might not match the performance recorded over the last few years, law firms' finances have certainly been helped by growth in bankruptcy and financial restructuring, litigation, and finance and capital markets activity. At the time of writing, the industry is on track to end 2020 with mid-single digit revenue growth and reduced expenses.

As a result, projected net income and profit per equity partner (PPEP) could be in the mid-to-high single digits. Behind the industry averages, we see wide dispersion[2] with the market favoring the largest and most profitable firms. That said, within any market segment, we see firms outperform—largely due to their brand and practice mix, with more than a few firms projecting record profits.

Looking ahead to 2021, we envisage the market will reward firms that not only have strong differentiated brands, but also have a diverse practice and industry mix. Growth is more likely to come from the US and UK than from other markets, although some firms are expecting demand growth among their Asian, European and Canadian practices.

Unlike the trend seen in recent years, firms view litigation and bankruptcy and financial restructuring as primary drivers of growth continuing on from 2020. There is mixed sentiment about the expected level of mergers and acquisitions (M&A) activity. But positive momentum seen in M&A, particularly relating to private equity during the second half of this year, is tilting the outlook toward a more positive picture than previously anticipated.

And reflecting the bifurcation in economic performance we have seen at the macro level, we would expect to see growth in demand for legal services coming especially from the technology, life sciences, healthcare, and financial services industries.

Having witnessed a successful transition to remote working, the COVID-19 pandemic has also accelerated a number of trends related to greater operational efficiency already evident in the industry. While we do not think this heralds the beginning of an entirely remote legal industry, we expect that some measure of remote working will become a permanent feature of the law firm of the future.

This creates opportunities for greater operational efficiency—including rethinking office space and configuration, and the appropriate level and composition of professional support leverage. We also expect there to be a continued focus on billing and collections, given the direct positive impact this has had on revenue this year.

It also raises questions around how to develop new business and train associates. The longer the COVID-19 pandemic impacts market activity, the greater the likelihood that firms will examine their lawyer headcount and leverage. And with the increasing dispersion in law firm performance, we anticipate lateral poaching to continue, if not accelerate, driving firms to examine how they compensate partners. We also expect more consolidation through mergers between firms of a similar size and acquisitions of smaller firms.

Looking forward, given that law firms tend to fare better than other industries in a challenging economic environment, we remain optimistic about 2021. We expect that the market will favor firms with a strong brand who stay close to their clients and have the right practice mix. While these factors will drive topline growth, we also expect that firms who capitalize on the success of this great experiment in remote working to accelerate further adoption of operational efficiencies, will be rewarded.

Our more detailed findings and projections are presented in this advisory report, and we hope that you will find it to be informative. As ever, we look forward to your feedback.

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[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 thirdparty providers of legal services, our information is mostly anecdotal. Sources include the "Citi Annual Survey Database" of 212 US-and UK-headquartered firms, including 44 Am Law 1-50 firms, 37 Am Law 51-100 firms, 55 Am Law Second Hundred firms, and 76 additional firms; 138 firms from the "Citi Flash 1H'20 Survey (Q2 Performance and 2021 Projections)," including 32 Am Law 1-50 firms, 21 Am Law 51-100 firms, 37 Am Law Second Hundred firms, and 48 additional firms; 182 firms from the "Citi Flash Survey," including 44 Am Law 1-50 firms, 31 Am Law 51-100 firms, 48 Am Law Second Hundred firms, and 59 additional firms; 88 firms from Citi's "Coronavirus: How Are You Responding? Surveys" conducted during March to October 2020; and the "Law Firm Leaders Confidence Index" which reports the forward-looking opinions of law firm leaders from 166 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.

Part I:
The legal market in 2020

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A. Overview

Prior to the emergence of the pandemic, 2020 began on solid footing for the industry with strong inventory and demand levels.

With most of the first quarter having passed before the pandemic actually started to affect the industry, we saw strong demand and revenue results. Importantly, we also saw strong inventory levels entering the second quarter. The combination of strong first quarter revenue and inventory growth placed the industry in as comfortable a position as it could have hoped for going into a very challenging second quarter.

Understandably, at the start of the pandemic, firms feared that we might see median declines of 15% in demand and revenue, with the latter also driven by a projected 11% lengthening of the collection cycle. While the second quarter did see a drop in demand, it was not as severe as anticipated, and revenue growth for the first half was actually better than the same period of 2019—helped in large part by the strong performance seen in the first quarter.

Through the first nine months of 2020, we saw average revenue growth of 5% over the same period of 2019, driven largely by an increase in the value of total hours worked and firms collecting on strong mid-year inventory levels, despite some lengthening in the collection cycle. Meanwhile, demand contracted by 0.7%. We also noted a shift in the nature of demand for legal services to more senior level advisory work and less highly leveraged work, driving an ultimate shift in the mix of work toward more senior timekeepers and reflected in an increased value of total hours worked.

We also saw inventory growth of 7.4% at the end of the third quarter, signaling a strong end to 2020, assuming that firms are able to collect. There is a mix of views on year-end collections in the market. Some firms are concerned that their success in collections through the first nine months might hurt their ability to collect as much as they typically would in the fourth quarter. Others, who may have already met their revenue targets and are concerned about 2021, are considering holding on to current inventory for collection in 2021. Nevertheless, we expect to see a push for collections during the fourth quarter by most firms.

Total lawyer headcount was up 1.4%, with some of the growth due to the lack of attrition in a volatile operating climate. Meanwhile, equity partner headcount grew slightly, up 0.2%, continuing the longstanding trend of careful equity partner headcount management. As a result of lawyer headcount increases outpacing equity partner headcount growth, we saw lawyer leverage increase by 1.6%. And as lawyer headcount and leverage grew while demand declined, we saw lawyer productivity decline by 1.3%. As mentioned above, the current environment has seen a comparatively greater decline in associate productivity than partners. Indeed, for many firms, partner productivity has improved.

Total expenses were down 2.1% for the first nine months, due in no small part to the agility we have observed across the law firm industry. With attrition grinding to a halt and headcount up over last year, this expense relief has been driven by a reduction in operating expenses, which declined 5.3%, while compensation expenses were still up 1.9%. We are hearing that some firms are prepaying expenses, especially where they have met their revenue targets, in an effort to manage expense growth in 2021.

Looking at the results by revenue size, Am Law 1-50 firms substantially outperformed the rest of the industry in revenue (up 6.8%). This was driven by an increase in the value of total hours logged, as rate increases outpaced other segments and demand shifted to a more senior mix of timekeepers—as well as by their focus on collections.

Am Law 1-50 firms fared better than other market segments in terms of demand performance, seeing a 0.2% drop in demand, compared with a 1.3% decline for Am Law 51-100 firms and 1.9% declines for Am Law Second Hundred firms and firms outside of the Am Law 200. While these segments trailed Am Law 1-50 firms in revenue growth, they achieved greater expense reductions, helping to protect, if not widen, their margins. Inventory growth was strong for all segments, suggesting that if firms are able to collect during the fourth quarter, we are likely to see a decent year-end as an industry average across all segments.

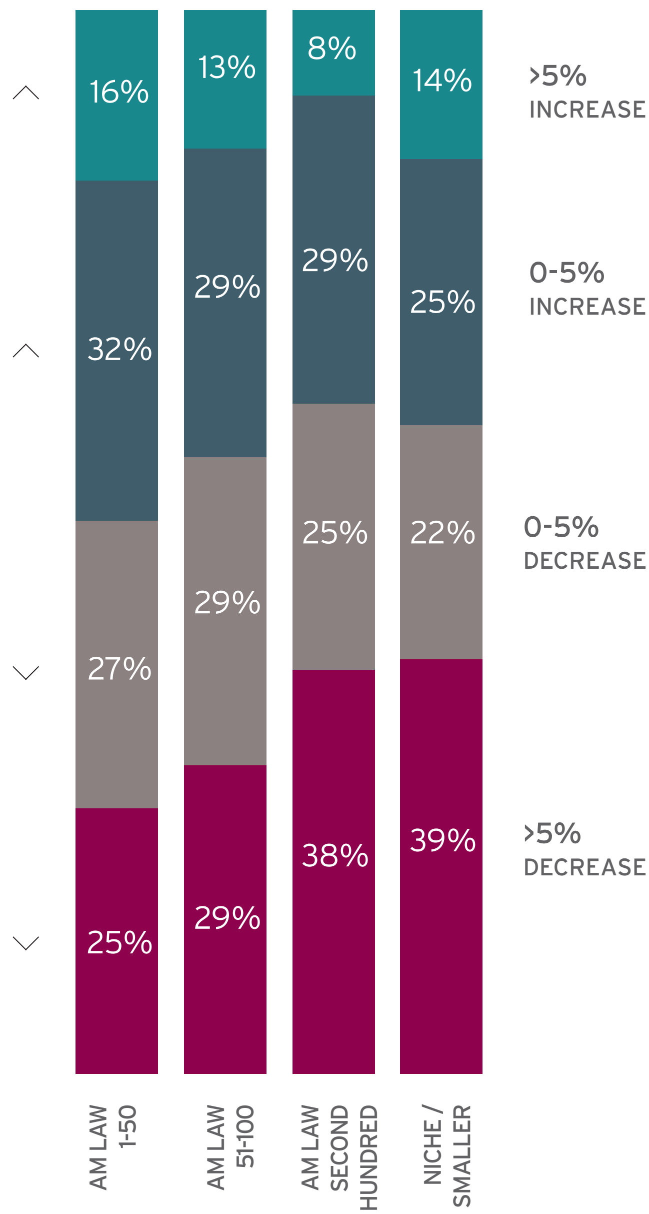
If firms continue to manage margins—remaining focused on both collections and expense management—we are optimistic about full-year 2020 performance and believe there is likely to be modest momentum going into 2021. We project that 2020 revenue growth will be in the mid-single digit range and, with the benefit of expense reductions, PPEP growth for the industry could be in the mid-to-high single digit range.

As with prior years, we see dispersion within every market segment (*illustrated in Chart 1*), suggesting that within each segment, we are likely to see a number of strong performers, particularly among Am Law 1-50 firms. We also anticipate that this dispersion will drive further industry consolidation in 2021, as discussed later in this report.

Venturing beyond the US legal market, it is more difficult to provide a telling forecast on performance. Competition in London between large UK firms and US firms with a strong presence in the UK market is expected to continue, as will lateral movement between them.

Currently, lateral moves tend to be away from UK firms to US firms. The current competitive environment has caused larger UK firms to adjust compensation for associates and reconsider their partner compensation systems in order to compete better. Looking to Europe, expansion by US firms has slowed, but we believe we will not see any withdrawal of global firms from the market.

CHART 1. DEMAND DISPERSION BY AM LAW SEGMENT 9MO'19-'20



Source: Citi Flash Survey © Citibank, N.A. October, 2020

We also note that, at the time of writing, the UK and Europe have not yet reached a Brexit deal. If no deal is reached in the coming weeks, UK firms and possibly some US firms may experience problems with their cross-border practices. This could be further complicated by Ireland limiting the ability of UK firms to practice in Ireland. While there is still time to work out a deal, firms in the meantime need to plan for potential alternative outcomes.

Business is improving in Asia, with a renewed focus on infrastructure, cross-border finance, and commodity trading. However, we have seen a few firms reduce their practice size or withdraw from mainland China and Hong Kong. On the other hand, Singapore is strengthening its regional position. The city-state has been the target of some additional growth by Western firms, as it is becoming the Asian regional hub for legal work.

International arbitration, energy, finance, infrastructure, and commodity trading are some of the avenues of interest. The city-state itself wants to become a technology center, but the extent of that remains to be seen. Singapore is also hoping that geopolitical problems in China and Hong Kong will be to its benefit as a services hub.

It is not difficult to open a limited practice license in Singapore, but there are various restrictions, including the recent announcement about raising the salary requirements for hiring expatriate lawyers. Most of the regional firms focus on cross-border work, not local work. Most offices of international firms are relatively small, and it remains to be seen how profitable they will be over the long run. Recruiting is challenging, and the COVID-19 pandemic has made it especially so. Nevertheless, we expect to see more expressions of interest in Singapore in light of firms leaving or reducing their footprint in China and Hong Kong.

Finally, Canadian law firms have reported solid performance similar to their US counterparts, with near parallel levels of success when it comes to remote working. By and large, it is clear that firms with a global practice have mostly strengthened their overall practice and economics.

B. Why results have defied market odds

Our overriding take is that the worst case performance scenarios feared by the industry at the start of the COVID-19 crisis have not come to pass. This is down to several key factors. First, the industry, as discussed, saw the strongest first quarter demand, rate, and revenue growth numbers seen in several years. The industry also ended the first quarter with increased inventory levels. These solid results placed many firms in as strong a position as they could have hoped for going into this crisis. Additionally, strong first quarter growth, together with a focus on collecting inventory during the second quarter, also helped drive strong first half results.

Second, certain legal practices have fared very well during this crisis. The performance of firms has differed based on practice mix. Bankruptcy and financial restructuring, litigation and regulatory investigations, and finance/capital markets have been particularly strong. Firms also reported busy corporate advisory practices. Other stronger performing practices included intellectual property and private client/trusts and estates. These practices helped soften the overall blow.

Third, we noticed a greater focus on billing and collections, as firms recognized that partners controlled this important liquidity lever through their efforts, helping drive revenue growth. Firms across the industry have told us that they now require their lawyers to enter time on a daily basis. Recorded time is subsequently reviewed on a weekly basis.

Partners have been encouraged to send bills more frequently, and perhaps in smaller amounts, be in regular touch with their clients about payment of bills, and flag early with management where there might potentially be issues with bill payment.

While the industry anticipated clients delaying bill payment and asking for greater discounts, most firms have told us this has not been their experience. Indeed, the focus on billing and collections has probably been the most common trend we have seen across the industry, and the direct impact it has had on firm revenue has been demonstrated in the positive revenue results seen this year.

Finally, firms have enjoyed a reduction in expenses, some due to deliberate decisions taken and some a result of the shifts brought about by the pandemic. Typically, we saw the cancellation of law firm retreats and other events and the curtailment of business development efforts and travel. Firms delayed or canceled major capital spending projects where they could. We also saw a reduction in the use of temporary and contract staff.

Some firms furloughed onsite staff in the early days of the pandemic. As firms reopened offices, they may have since reinstated furloughed staff, while others decided to terminate them. Some firms reduced lawyer and staff salaries, although we have seen at least a partial reversal of these decisions at many of those firms. We also saw some firms delay their fall associate classes to January 2021. And we saw firms make permanent reductions in business support staff and secretarial support—a trend we expect to see continue in 2021, as discussed later in this report.

Lessons learned in this crisis

Every crisis is a learning curve that brings about profound changes in its wake. The COVID-19 crisis is no exception and our law firm clients highlighted several valuable lessons during 2020:

THE SHIFT TO REMOTE WORKING HAS LARGELY BEEN SUCCESSFUL. In an industry that, by certain benchmarks, has lagged other industries in the adoption of remote working, the sudden move to full remote working was largely viewed as very successful. This was due in large part to the technology investments firms made in recent years. While it might not be ideal as a long-term solution to have law firms operate fully remotely, firms reported to us that they were able to make a seamless transition to remote working, for many in the space of a weekend, and continue to provide the same level of quality legal services to clients.

FREQUENT, CONSTANT, AND TRANSPARENT COMMUNICATION IS CRITICAL. Law firm leaders cited the importance of frequently staying in touch with their people, whether via written communications or more effectively through video meetings. Frequent meetings, whether it be the managing partner addressing the firm, or practice heads leading partner meetings, were viewed as a means of keeping the business focused throughout this crisis. At the firm level, virtual managing partner town halls were common. And many talked of their emphasis on holding meetings at a set time to provide some measure of constancy given the uncertainty of the times. Transparency was also seen as key, with firm leaders noting that in making hard decisions around expense reductions, especially salary reductions and job cuts, it was critical that they be transparent with their people in order to gain acceptance of these decisions.

BEING PREPARED AND ACTING EARLY HELPED FIRMS MANAGE THROUGH THIS CRISIS. This was especially true in relation to the successful transition to a remote working environment, and to the cash flow management decisions firms took. Early in this crisis, continuity of business working groups were hard at work ensuring that technology licenses could support a fully remote workforce. Decisions were constantly being made about business travel, in-person interaction with clients, and upcoming events. From the vantage point of Citi Private Bank, we observed a large number of firms increasing their lines of credit and, in some instances, drawing down partially or fully on even committed credit lines to ensure they would be in a comfortable cash position. We also witnessed firms holding on to undistributed income, especially once the April 15 tax payment date shifted to July 15.

STAYING FOCUSED ON THE BUSINESS AND MAINTAINING A GROWTH MINDSET REALLY MATTERED. The results showed that while the industry saw a decline in demand from mid-March, there were many firms who continued to see growth throughout the year—largely dependent on practice mix. Firm leaders also highlighted the importance of celebrating successes along the way as a powerful motivator in this challenging environment.

IN A CRISIS, TOP PERFORMERS WILL RISE TO THE OCCASION. On the other hand, lesser performers need more direction. In good times, law firms are often slow in dealing with performance issues. This crisis has shone a light on differing performance levels. This has caused a number of firms to accelerate performance reviews, as they recognize that it is bad for economics and the firm's culture to not act on performance issues as they occur.

A STRONG FIRM CULTURE AND SENSE OF COMMUNITY ARE ESSENTIAL TO WEATHERING A STORM. We saw a strong emphasis on strengthening firm culture and recreating a sense of community in a virtual world. Aside from regular meetings as described above, firms employed a wide range of innovative and inspiring ways to build a sense of community—both to keep the business running and to ensure a healthy and positive mindset in these isolating and anxious times. This was seen as particularly critical for young associates who may have experienced isolation or may be challenged by shared living conditions. It was also true for people managing child care and schooling or elder care. We saw firms hold group fitness challenges, Netflix viewing parties, trivia competitions, and baking contests, to name a few. Firm leaders noted that of all the characteristics needed to get through the crisis, resilience and adaptability have been especially valuable.

STAY CLOSE TO CLIENTS, ESPECIALLY DURING A CRISIS. Some would argue that this crisis has made it challenging to bring on new clients, likely favoring the incumbent firm. For many, there was an emphasis on staying close to existing clients, and proactively finding ways to help them navigate through this crisis. As clients stopped traveling and worked from home, partners often commented on the greater accessibility of their clients and the ease with which they could arrange calls with them. Law firm leaders actively encouraged their partners and lawyers to reach out to clients on a regular basis. While early on there was a rush of COVID-19-related emails flooding client inboxes, firms observed quickly that the more tailored the advice, the greater value clients placed on it. And while some might argue that it would be hard to lure a client away from the incumbent firm, marketing and business development experts would argue that this crisis was an ideal opportunity for firms to build their client base where the incumbent had become complacent.

HAVING A BALANCED PRACTICE AND INDUSTRY MIX CAN MODERATE THE IMPACT OF A CRISIS. This has been very clearly demonstrated in the different experiences we saw in 2020 outlined earlier in this report. Practice and industry diversity will hold firms in good stead in challenging times.

FOCUSING ON TOP TALENT IS CRUCIAL TO MITIGATE THE RISK OF POACHING. One of the characteristics of industry performance in 2020 was the widening gap between the largest and most profitable firms and the rest. This will no doubt create further opportunities for strong performers to capitalize on their outperformance by pursuing lateral talent.

THE COVID-19 CRISIS HAS CREATED EFFICIENCY AND INNOVATION OPPORTUNITIES. As noted earlier, we saw more rigor around billing and collections—a primary driver of revenue growth in this challenging environment. Firms are now rethinking the size and configuration of their office space. We saw a strong focus on reducing expenses and looking for further operational efficiencies from the start of this crisis, resulting in expense saves. Two such examples include firms reviewing secretarial and business support ratios and rethinking how much business travel will be truly essential in the future. And given that technology, whether it be video calling or remote access to firm systems, essentially enabled this industry to continue operating throughout 2020, we have seen a greater appetite to innovate and to adopt new technology.

We believe that some of these lessons will drive an acceleration of a number of trends that have emerged in recent years. We discuss these and other trends to watch in 2021 and beyond later in this report.

Part II:
Looking ahead to 2021 and beyond

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A. Citi Private Bank's global economic outlook

In the immediate aftermath of the declaration of a COVID-19 global pandemic, Citi Private Bank predicted big GDP declines in 2020, which have since been reflected in the data. However, we also expect sharp recoveries almost everywhere, with GDP reaching pre-crisis levels in most global regions between the second quarter of 2021 and first quarter of 2022.

As noted in our latest *Global Strategy Quadrant,*[3] China and the US look set to outperform European economies. Inflation and interest rates should stay low. There is a significant risk of divergence between the best- and worst-performing economies in this crisis. In the main, global GDP is likely to rebound by 4.2% and 3.6% in 2021 and 2022 respectively from a 4% contraction in 2020.

The US is expected to post growth rates of 3.9% in 2021 and 3.2% in 2022 from a 4.8% contraction in 2020. The EU is expected to recover from an 8% contraction in 2020 to growth rates of 4% and 3% in 2021 and 2022 respectively, while the UK is expected to recover from a 6% contraction in 2020 to growth rates of 3% in 2021 and 3.5% in 2022. Meanwhile, China, which is expected to grow by 2% in 2020, will likely post growth rates of 6% and 5% in 2021 and 2022 respectively.

With large-scale production of vaccines likely, together with development of monoclonal antibody treatments, an end to the global pandemic is likely around midyear. We expect a sharp broadening out of the world economic recovery in the second half of 2021. As a consequence, cyclical industries could see a rapid bounce back.

B. Legal industry outlook for 2021

We are working with so many unknowns that have made it challenging to provide a forecast for 2021. The positive momentum we have seen during the second half of this year makes us optimistic about 2021. We would however expect that the strong first quarter results we saw in 2020 will create a high hurdle for firms to achieve demand and revenue growth early in 2021, even with the momentum we have seen building.

We also anticipate accelerated expense growth, as the sharp expense reductions recorded this year create a difficult year-over-year expense comparison in 2021, particularly as firms return to the office in some form during the course of next year. However, this may be aided by a continued focus on operational efficiencies. Given the number of unknowns about next year, we see some firms considering prepaying expenses, delaying sending invoices, and resetting partner distribution policies.

Additionally, we anticipate continued dispersion in performance, driven by practice and industry mix. That said, based on the experience of the legal sector in prior downturns and during 2020, we believe that this industry is likely to perform better than many would expect in 2021.

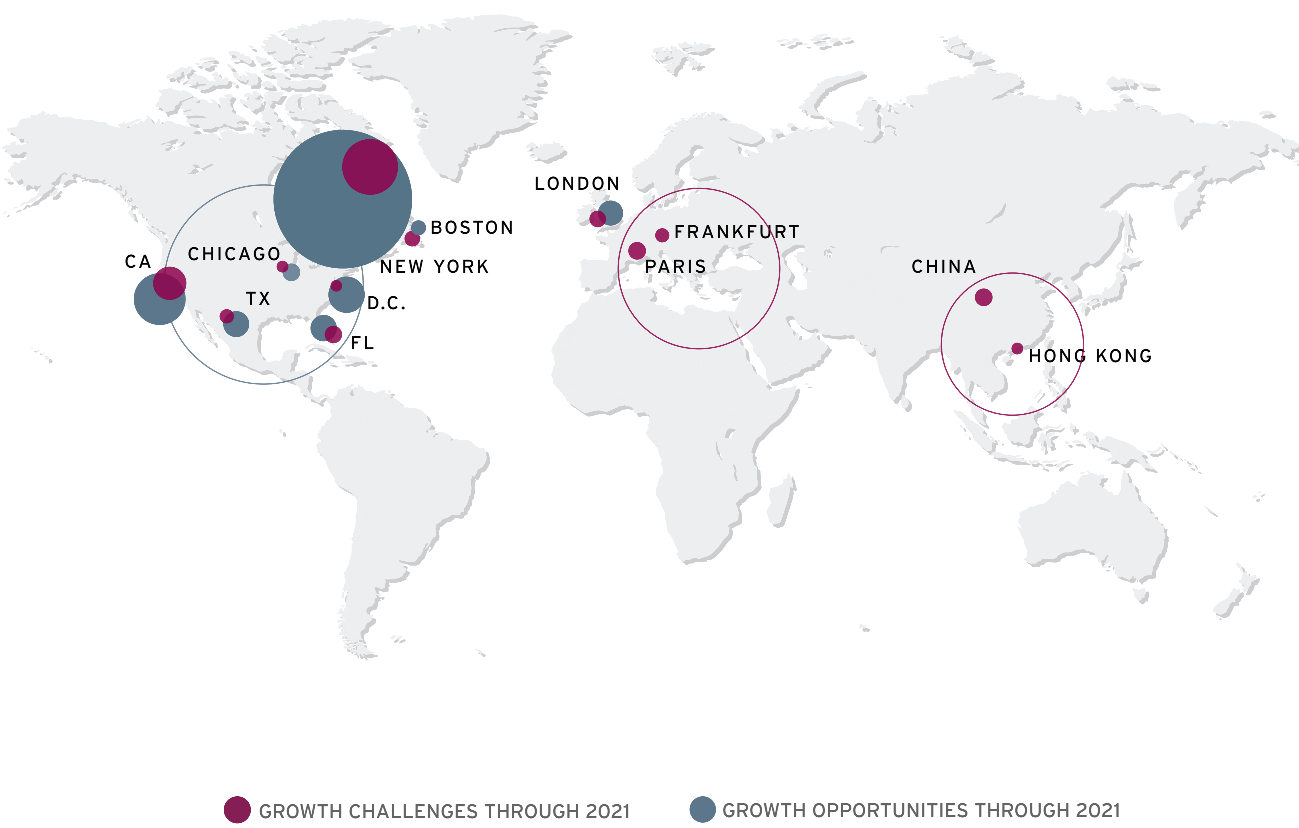
[3] Citi Private Bank's CIO Global Strategy Quadrant - Now to Prepare for COVID's Departure, November 20, 2020

1. GROWTH OPPORTUNITIES AND CHALLENGES BY REGION

Based on our flash survey conducted in mid-2020 (*illustrated in Chart 2*), law firms across the industry are betting on the US as the primary driver of law firm revenue growth in the year ahead. Indeed, the only market outside of the US marked as an area of growth is London. We have however been hearing from some firms recently that they are also optimistic about their Asian, European, and Canadian practices in 2021.

Within the US, New York is viewed as the biggest growth market, followed by California and Washington DC. Firms also see growth opportunities in Florida, Chicago, Boston, and Texas. Regarding Texas, in addition to the pandemic, this market has faced the challenges of low oil and gas prices, suppressed energy demand, and new market entrants poaching talent from local firms. That said, alternative energy development, technology, restructuring, and purchases of distressed assets will continue to drive activity.

CHART 2. GROWTH OPPORTUNITIES AND CHALLENGES BY REGION THROUGH 2021



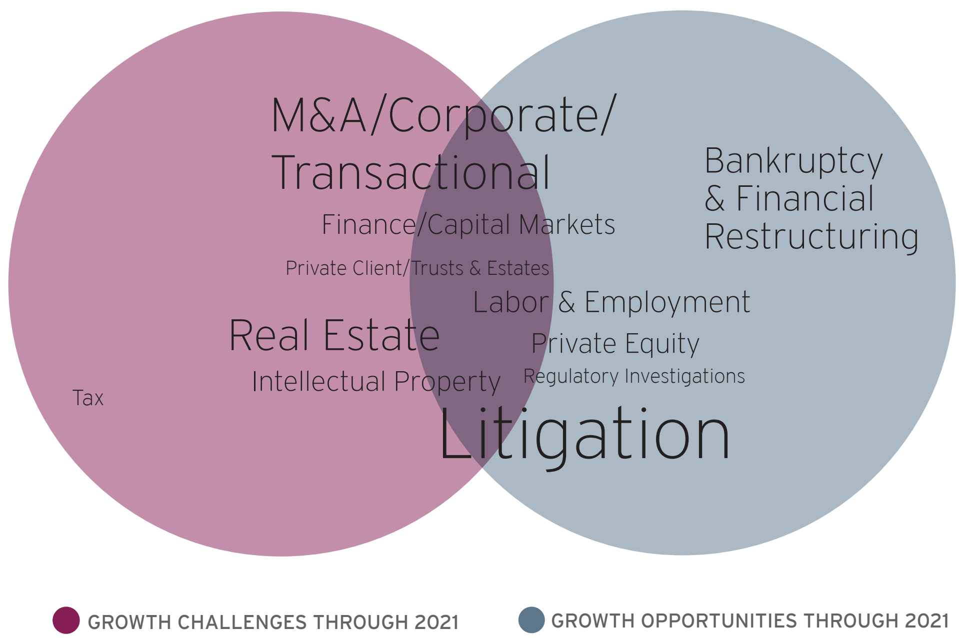
Source: Citi Flash Survey © Citibank, N.A. July, 2020

2. GROWTH OPPORTUNITIES AND CHALLENGES BY PRACTICE

In a shift from recent years, firms see litigation as the primary growth practice in the coming year (*illustrated in Chart 3*), followed by bankruptcy and financial restructuring. Beyond traditional litigation, firms also expect to see increased activity in regulatory investigations under the new administration, likely gaining steam from the middle of 2021. Several firms have also noted infrastructure as a growth driver in the coming year, particularly in Asia.

On the other hand, the outlook for M&A/corporate/transactional practices is mixed—a significant shift from the last several years, where we saw these practices as the primary driver of demand growth. That said, we have started to hear positive news about M&A work from the third quarter of this year. And while finance/capital market practices have been strong performers in 2020, the outlook for 2021 is mixed.

CHART 3. GROWTH OPPORTUNITIES AND CHALLENGES BY PRACTICE THROUGH 2021



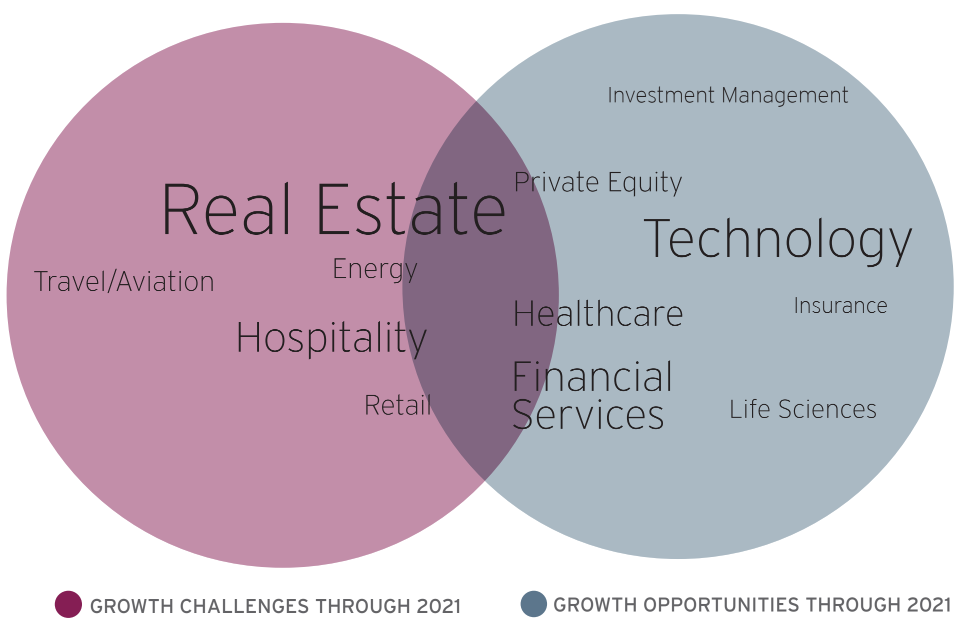
Source: Citi Flash Survey © Citibank, N.A. July, 2020

3. GROWTH OPPORTUNITIES AND CHALLENGES BY INDUSTRY

Law firms are likely to see industry segment growth opportunities mirroring the starkly different experiences across industries seen during this pandemic (*illustrated in Chart 4*). Firms see technology as the leading growth industry for legal services, driven both by transactions and a likely increase in regulatory oversight.

The industry is also likely to see high levels of growth from financial services, life sciences, healthcare, and private equity. On the other hand, real estate, travel, hospitality, energy, and retail are industries expected to remain under pressure.

CHART 4. GROWTH OPPORTUNITIES AND CHALLENGES BY INDUSTRY THROUGH 2021



Source: Citi Flash Survey © Citibank, N.A. July, 2020

4. GROWTH THROUGH CONSOLIDATION

We expect to see more lateral activity as outperforming firms leverage their strong position to further drive the gap between themselves and the rest of the industry. And while 2020 has demonstrated the resilience of this industry, demand is down for many firms, likely driving further consolidation as firms look to build scale and diversification. It is likely that we will see some activity in the acquisition of smaller firms and mergers involving smaller and midsize firms. While it is challenging to negotiate a merger during a pandemic, we may see larger mergers and simply see firms delay the effective merger date. While mergers between large firms are more difficult, the desire to have larger platforms domestically and internationally may produce some surprise combinations.

C. Key trends to watch

This pandemic has accelerated a number of existing trends affecting growth and operational efficiency, how lawyers work, how equity partners are compensated, and how firms fund their businesses. We believe that the following will be the key trends to watch in 2021 and beyond:

1. MORE OUTSOURCING BY LAW DEPARTMENTS

Over the past several years, in this increasingly complex legal and regulatory environment, we have seen corporate law departments grow their headcount while managing their use of outside counsel and focusing on the efficient delivery of legal services and containment of legal fees. However, in prior cyclical downturns, we have seen law departments under pressure to reduce fixed costs, including headcount. As a result, they have tended to outsource more work to law firms.

We envisage that law departments will continue to carefully manage their use of outside counsel in an effort to move some legal spend from a fixed to a variable cost. While they now have many more choices in outside legal service providers, we could see some work currently handled in-house shift to law firms.

2. A GREATER FOCUS ON BUSINESS DEVELOPMENT

We expect to be in a highly competitive environment in 2021, where firms are at risk of client poaching by others. Business development has become more challenging in this remote environment, requiring firms to rethink how they should approach this in the coming year. While lawyers are not able to travel to meet existing and potential clients in person as easily as before, many have talked of how much more accessible their clients have become, and how they have been able to build deeper relationships through this shared experience.

We would anticipate that in an effort to gain market share in this ongoing challenging environment, firms will need to focus on how to deepen and broaden relationships with their existing client base while attracting new clients, perhaps from firms who have become complacent. As firms review their professional staffing levels, we suggest that business development staff would be an important investment for firms in this highly competitive environment.

3. MORE DIVERSITY IN PRACTICE, INDUSTRY AND GEOGRAPHY

As we noted in our review of 2020 industry performance, firms with litigation, bankruptcy and financial restructuring, and finance and capital markets practices balancing their M&A practices fared better than firms more heavily reliant on M&A. Similarly, firms with a lower dependence on real estate, travel, and hospitality fared better than firms more heavily reliant on these industries in 2020. We would envisage that firms will continue to examine their practice and industry mix—and footprint—in the coming year.

4. A COMBINATION OF REMOTE AND OFFICE WORK

The current conventional view is that remote working is here to stay. The first question is for how long the legal industry can continue to operate almost fully remotely. The second question is around the extent to which remote working will become an element of the law firm work environment in the longer term.

The answer to the first question is influenced largely by macro conditions outside of the control of law firms—particularly dependent on how long it will take to have a widely available vaccine which people are then confident using. As we have seen during 2020, concern over health and wellbeing, as well as the responsibilities of child and elder care, have been important factors in the lack of desire for many to return to the office. Firms located in high density cities, requiring long commutes, face unique challenges in returning to the office.

In our conversations with law firm leaders, we sense remote working fatigue and a strong desire to return to the office when it is safe to do so. Law firm leaders also talk of the challenges of developing associates in a profession that is steeped in learning by sitting at the side of a partner or more senior lawyer. Indeed, firms are starting to reopen their offices in certain locations. Many believe that once firms achieve critical mass, more people will return to the office.

Considering the second question, we envisage a future work environment that combines the best aspects of both remote and office work. We have already seen a number of firms announce plans to allow a balanced schedule of remote and office work. The success of remote working will allow firms to do more in the future to offer more flexible remote/office arrangements and retain key talent. It will also enable firms to hire talent from anywhere, including lower cost locations. The mix of remote and office work will depend in part on the willingness of people to return to the office and the competition for talent.

5. CHANGES IN OFFICE SPACE

Law firms who have moved in the last few years have already made strides in reducing and redesigning their footprint. Large partner offices have become a thing of the past, as firms have adopted standardization in the size and layout of offices. We have also seen more focus on creating collaborative workspaces, such as conference rooms, open staircases, and cafes. We expect these trends to continue, factoring in appropriate social distancing.

As firms continue to review their use of support services, including making decisions around scaling back or eliminating certain services and outsourcing more, this may offer further opportunities to redesign office space. With more remote working and less desire to make long commutes, we may also see firms look for space in lower cost locations, closer to where people live.

However, landlords are unlikely to want to take back space in the current environment, and the opportunities to sublet space will be limited. The opportunity to reduce occupancy expenses will have a comparatively longer timeframe than other expense opportunities. Sub-leasing of excess space will be difficult until the commercial real estate market improves. Firms will likely need to wait until their leases are up for renewal to see this major expense reduction opportunity.

6. RETHINKING PROFESSIONAL AND SUPPORT STAFF LEVERAGE

For the past several years, we have seen law firms actively reduce their professional and support staff ratios. The fully remote work environment has shone a light on the opportunities to further rationalize the operation of a law firm, including the size and composition of support services. While some roles that were initially furloughed have since been reinstated, others have been eliminated this year.

We expect further adjustments in the number of secretaries, paralegals, and hospitality staff. On the other hand, we are likely to see an increase in technology, business development, pricing, and billing and collections staff. We also expect that some of the expense reductions that were made in 2020 will be lost as firms reopen offices, and require the reinstatement of some onsite roles eliminated this year.

7. CONTINUED EMPHASIS ON OPERATIONAL EFFICIENCIES

There are a number of opportunities for firms to achieve efficiencies, beyond rethinking real estate and professional and support staffing as described above. In rethinking professional and support staff leverage, we expect more outsourcing of support services, including technology support and procurement.

With technology essentially enabling this industry to continue operating in a fully remote environment, we have seen an increased appreciation for investment in technology. To continue to support the efficient delivery of legal services in this changed environment, we expect greater and faster adoption of technology than in the pre-pandemic legal industry.

Historically, the investments that law firms have made in technology have often been better than those made by their clients. This includes corporate law department clients, who may face challenges obtaining adequate budgets to invest in new technology. Looking forward, this investment advantage, if used well, will enable firms to continue to position themselves as a compelling option in the efficient delivery of legal services.

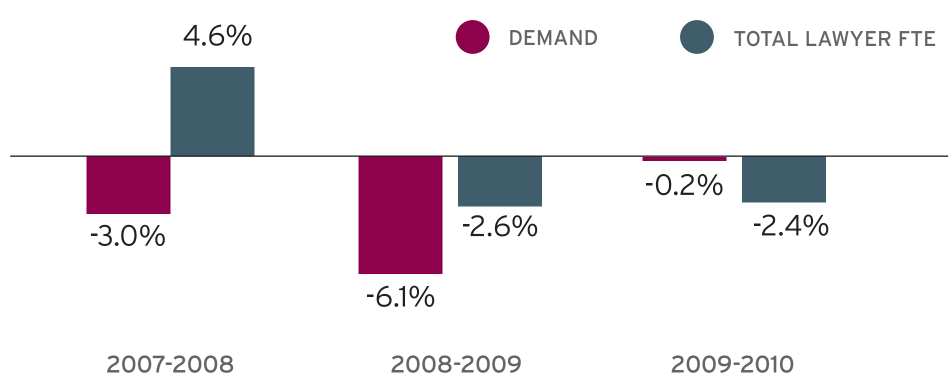
Given the success firms have had this year with the shift in how they approach billing and collections, we expect a continued focus on shortening the billing and collections process. We also expect more scrutiny around what is considered essential business travel, with perhaps more meetings with clients by video where it makes sense, creating an important expense save for firms.

8. REEXAMINING LAWYER HEADCOUNT AND LEVERAGE

So far, we have seen limited actions in reducing lawyer headcount, some of which were performance-based decisions made before the COVID-19 pandemic. We have sensed a reluctance on the part of most firms to make headcount adjustments. However, the longer this pandemic continues, the higher the likelihood that some firms who are experiencing a challenging environment might face hard decisions around headcount. It is worth looking at the actions taken during the 2008–09 recession and considering the lessons learned.

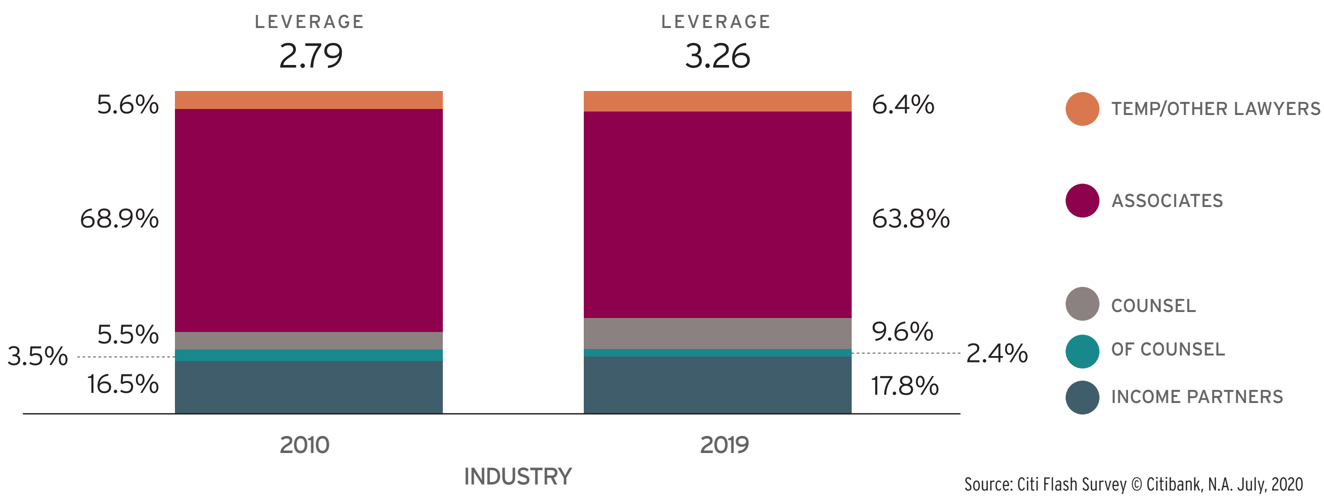
During the last recession, as the industry saw a 3% drop in demand in 2008, firms saw lawyer headcount growth of 4.6% (*illustrated in Chart 5*). In response to the downturn, by 2009, lawyer headcount had dropped by 2.6%. Meanwhile, demand declined a further 6.1%. Lawyer headcount reductions continued into 2010, at a rate of 2.4%, even as the demand environment began to stabilize. Most of the reductions occurred among associates, particularly junior associates.

CHART 5. DEMAND AND HEADCOUNT: 2007-10



Source: Citi Flash Survey © Citibank, N.A. July, 2020

CHART 6. COMPOSITION OF LAWYER LEVERAGE BY FTE: 2010 VS. 2019



Source: Citi Flash Survey © Citibank, N.A. July, 2020

Since 2010, as the industry has grown total lawyer headcount at an average annual rate of 1.8% and increased leverage at an average annual rate of 1.7%, we have seen the typical law firm leverage model become more senior (*illustrated in Chart 6*) and more expensive. As we wrote in last year's client advisory report,[4] the shift to a more senior leverage model has not necessarily led to a more profitable model.

If firms are considering headcount adjustments, we would urge them to assess the contribution made to firm profitability by every layer of the leverage model, rather than the traditional approach we have observed in prior recessions of reducing associate levels, often among the most junior classes.

In our experience, a few years after the last recession, when activity levels had picked up again, firms often lamented to us that they faced a shortage of mid-level associate talent and salary pressure and regretted those earlier decisions. In our recent conversations with law firm leaders, this remains a clear memory, and we see a reluctance to make adjustments to junior associate classes.

If firms face hard decisions around headcount adjustments in 2021, they may want to make those decisions based on profitability, rather than seniority, taking a longer term view of what their needs will be when the inevitable recovery occurs. In particular, we note that for firms where their income partners cost more than they generate in revenue, they may want to take a closer look at their income partner ranks.

9. ADDRESSING COMPETITION FOR EQUITY PARTNERS THROUGH COMPENSATION

In what is likely to be another year of active lateral hiring, we would expect firms to focus on key talent retention. This will include examining ways to competitively reward their top performers. In recent years, we have seen a greater allocation of net income to top performers, including the increased use of bonus pools. We would expect this to continue, if not intensify.

[4] Citi Hildebrandt 2020 Client Advisory

10. RETHINKING FIRM CAPITAL

As we saw during the early days of the pandemic, access to liquidity was one of the key priorities of firms. With large firms reporting having enough liquidity to cover four months of expenses (as a median), we saw firms take a number of steps to manage cash flow. As we noted earlier, firms delayed partner distributions, increased and drew down on their lines of credit, increased loans, and examined their partner paid-in capital levels. Some reduced partner draws and lawyer and staff salaries, while a few furloughed or reduced staff. We would anticipate that, having survived this crisis, firms will continue to examine the ways in which they are capitalized, and in particular, we expect some firms to increase their partner paid-in capital levels.

11. OUTSIDE INVESTMENT IN LAW FIRMS AND FURTHER GROWTH IN ANCILLARY BUSINESSES?

A key topic that is receiving a lot of attention in the industry is the concept of allowing outside investment in US law firms, as we have seen in other countries. This is a complex issue that has many challenges and possible advantages. Many argue that allowing outside investment will provide greater access to legal services, though they should recognize that traditional law firms already provide substantial pro bono services. On the other hand, access to outside investment would also potentially enable firms to better compete with the likes of the Big Four and the many emerging alternative service providers with greater access to capital. While access to alternative sources of capital might be attractive, any investor is almost certainly going to demand a return on their investment above what most law firms could borrow for investment in their growth. Perhaps this is why we have not seen a rush to take advantage of the ability to take outside investment in jurisdictions that already allow this.

With the continuing growth in demand for, and providers of, efficient legal service delivery solutions, including the Big Four and the myriad of well capitalized alternative service providers, we see law firms looking to develop ancillary businesses to compete for this work. We note however that developing such businesses was common in the late 1980s and 90s, and most failed. There were three key reasons: (1) they were often set up inside the law firm and managed by a partner who also had practice responsibilities; (2) they often produced conflicts; and (3) firms found they could make a profit by simply practicing law.

Today, we see firms using various business models to establish separate businesses that operate independently of the firm. Some have created these businesses, while others have acquired an already existing business or taken an ownership interest in a business. They are being managed by business professionals or possibly a partner who has been taken out of the practice, and they are likely to be compensated based on the success of the business.

We have seen the most activity so far in litigation support services, and we expect to see law firms continue to explore ways in which to compete for this growing pie of legal services that is underpinned more by technology, project management, and efficient processes than by high level legal expertise.

12. AN EVEN GREATER FOCUS ON DIVERSITY AND INCLUSION

We saw law firms institute programs to work even harder on diversity and inclusion in 2020. In our conversations with leaders of law firms across the industry, we know that this is top of mind. We envisage that law firms will continue to make great strides in their diversity and inclusion initiatives in the year ahead.

Conclusion

The COVID-19 pandemic created numerous unprecedented challenges for the legal industry. The industry rose to these challenges, adjusted well to a remote work environment, and as a result, saw performance levels that exceeded expectations. If anything, this pandemic-impacted year demonstrated to us just how stable and resilient this industry is.

This would not have been possible without the strong leadership exhibited by law firm leaders, who demonstrated extraordinary adaptability and resilience in the face of these new challenges. We believe that the leadership we see in most firms today is more competent and focused than ever. We also note the strong performance of firms who have empowered executive directors, chief operating officers, chief financial officers, and other professionals to run the operation of the firm while letting partners focus on their practices.

Looking forward, there are a number of characteristics that we believe will drive success. Having a diverse practice and client mix will be key as firms pursue their growth strategies. We expect to see a continued focus on operational efficiencies and especially greater investment in technology. There is no doubt that some balance of remote and office work will stay with us, and the firms who can strike the right balance and continue to focus on maintaining a cohesive and inclusive culture will have greater success in attracting, developing, and retaining talent.

The legal industry typically weathers downturns better than expected and better than other industries. This has been the experience of 2020, and we expect the same to be true of the law firm industry's performance in 2021. We thank you for your continued support, and wish you a successful year ahead.

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