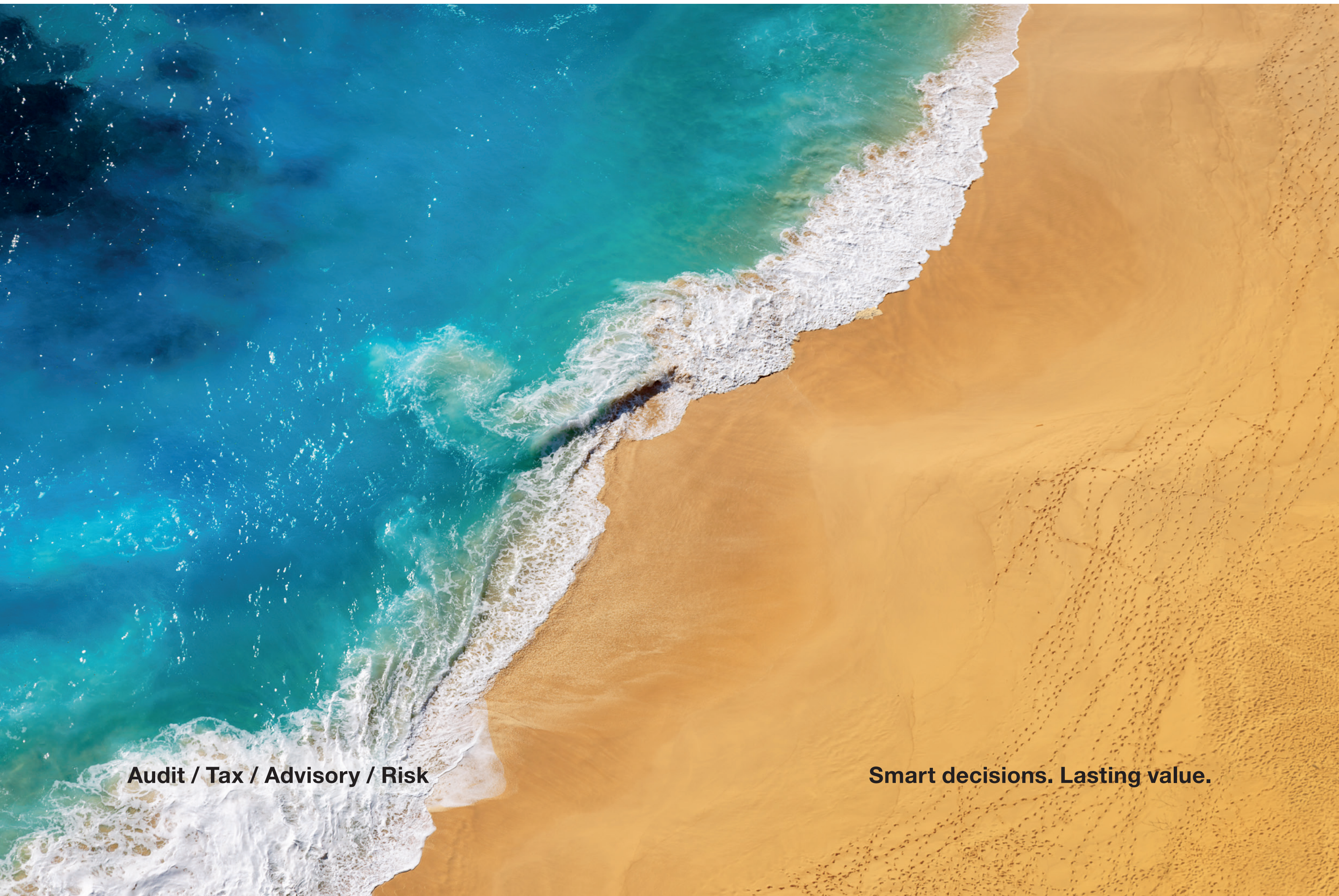
Crowe

Law Firm Benchmarking 2018

Providing clarity in the legal sector



Audit / Tax / Advisory / Risk

Smart decisions. Lasting value.

The big picture

Looking back over the past year, it is difficult to find an area of the legal market that has not seen change. In the face of changing regulation, as well as economic and political uncertainty, it is interesting to hear where law firms consider the largest challenges and opportunities lie.

The results of our annual law firm benchmarking, which are based primarily on results from participants with financial years ending in 2018, provide a timely snapshot of the industry's performance in the UK.

Despite the uncertainties around Brexit, the regulatory environment and the economy in general, the majority of law firms surprised us all, themselves included, by demonstrating revenue growth with the majority of those firms also enjoying improved profits.

This year, for the firms that experienced growth, the strongest performers were among the smaller firms with turnover up to £10 million and the largest firms with turnover above £50 million, though the aggregate growth rate across all participants was reasonable at almost 7%.

> "The strongest performers this year were firms with turnover up to £10 million and those with turnover above £50 million."

The increases in turnover were, on the whole, converted into profit; two thirds of participants saw an increase in profit per equity partner (PEP), with almost two thirds of those enjoying an increase of more than 10%. Of those firms that saw a decline in PEP, there was a fairly even split of the proportion between City and regional firms and it was the smaller firms that bore the brunt of the fall. For those that did see an increase however, it was also the regional firms that enjoyed the majority of the larger increases.

Brexit continued to be a source of concern for many, and understandably so given the lack of clarity that persists, but firms have not been idle in planning for other issues that are waiting on the horizon. Indeed, a large proportion of firms report to be exploring the opportunities around artificial intelligence (AI), as well as critically assessing other key internal factors to their success, such as pricing models and transparency.

Uncertainty appears to have encouraged most firms to focus on what they are good at, and the majority of participants are basing future growth expectations on expanding their existing market, rather than diversifying into new work types.

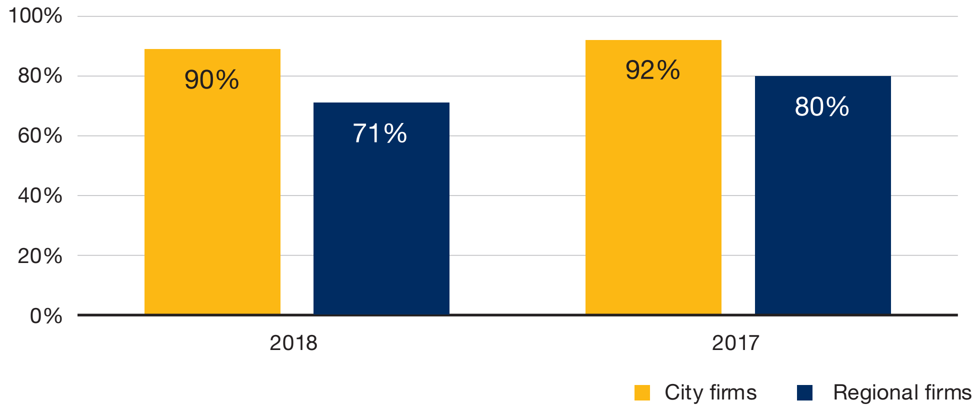
Staffing has played a pivotal role in most firms' plans with around 70% of firms increasing their headcount this year. However, it is not just new staff that firms are choosing to invest in; both City and regional firms identified a remuneration package which keeps pace with a market rate as a key factor in maximising staff retention.

Whether the increase in headcount has been a strategic move to prepare for future opportunities remains to be seen. Fees per fee earner have remained quite static both inside and outside of the City and so the increased headcount appears to be directly generating revenue, with little sign of excess capacity or increased productivity in the system.

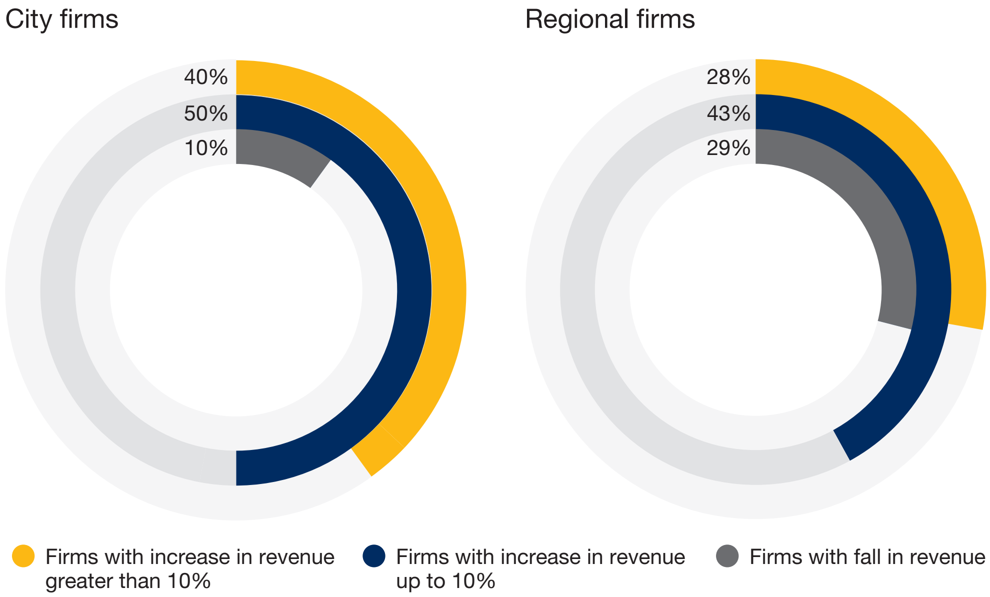
Although most firms continue to appreciate the importance of converting work in progress (WIP) into fees to ensure financial stability, this year we saw an increase in the average working capital life cycle for firms, especially those in the City. This was due to an increase in debtor days and it is critical that firms do not lose sight of the importance of good financial hygiene, especially when there is so much else to think about in the market.

Highlights from 2017–18

Percentage of firms that showed an increase in revenue



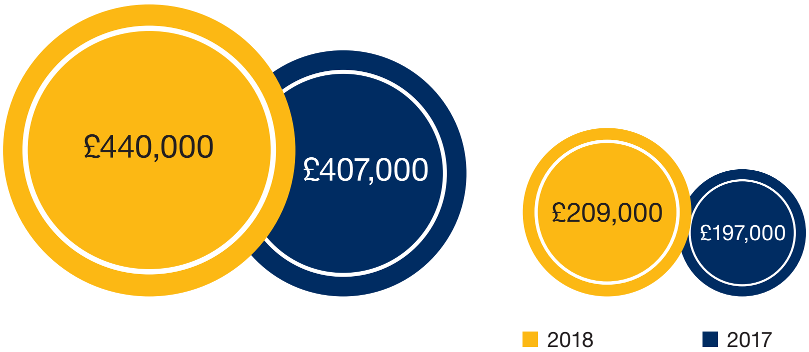
Revenue Growth



Average profit per equity partner (PEP)

City firms

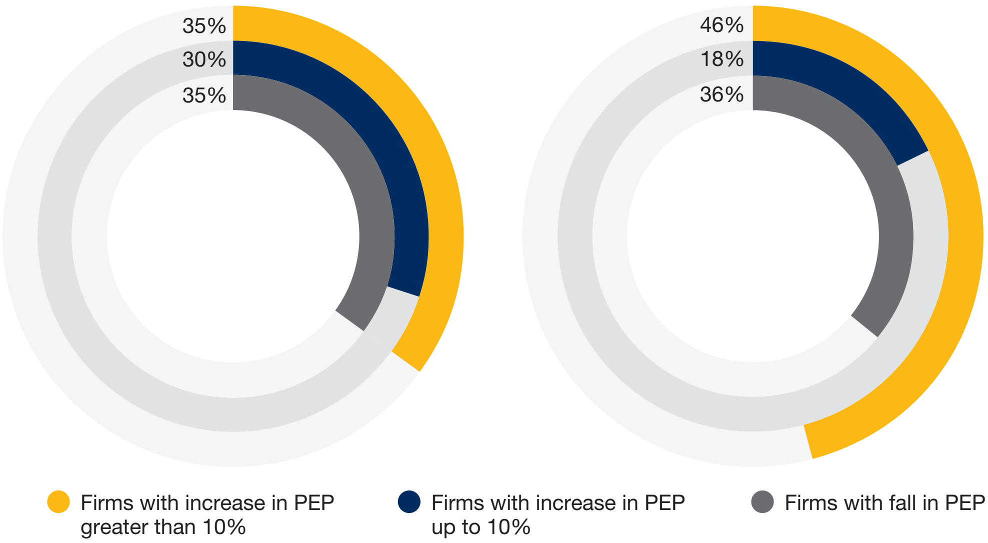
Regional firms



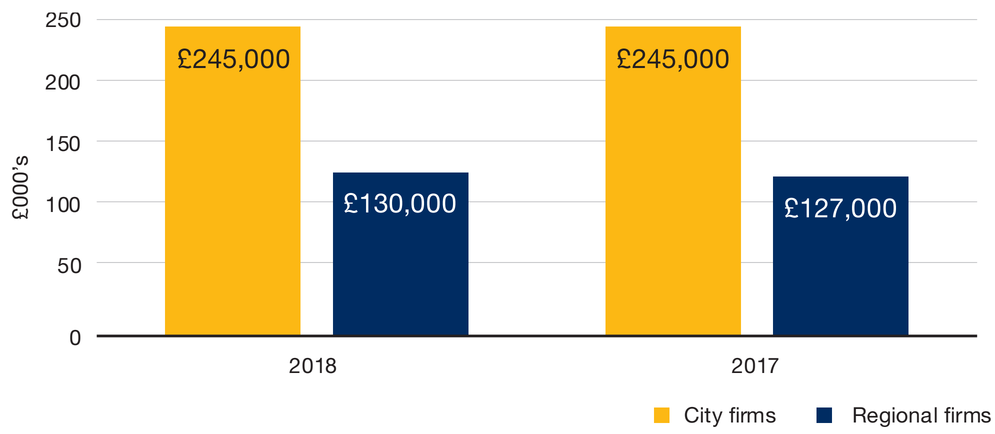
Changes in PEP

City firms

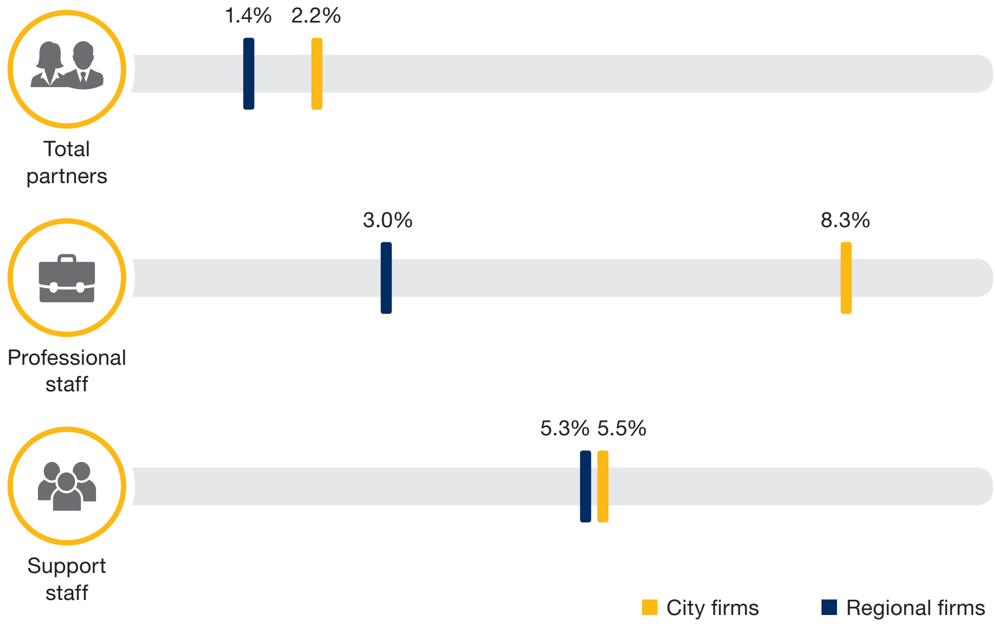
Regional firms



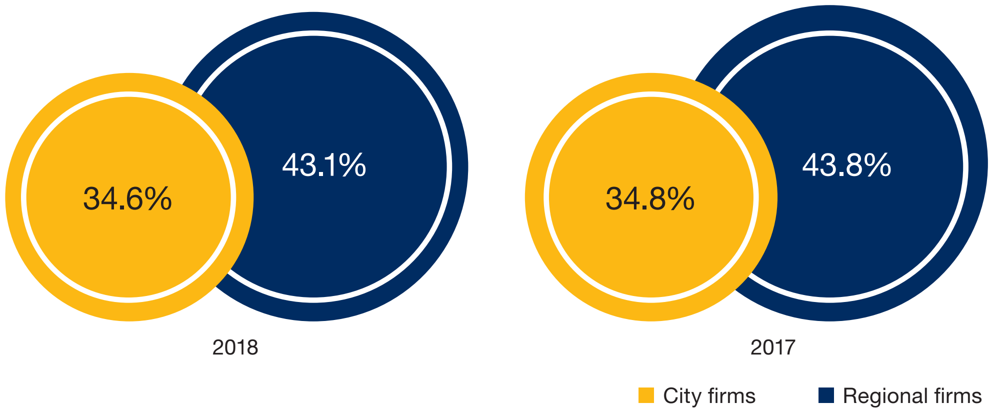
Fees per fee-earner (including partners)



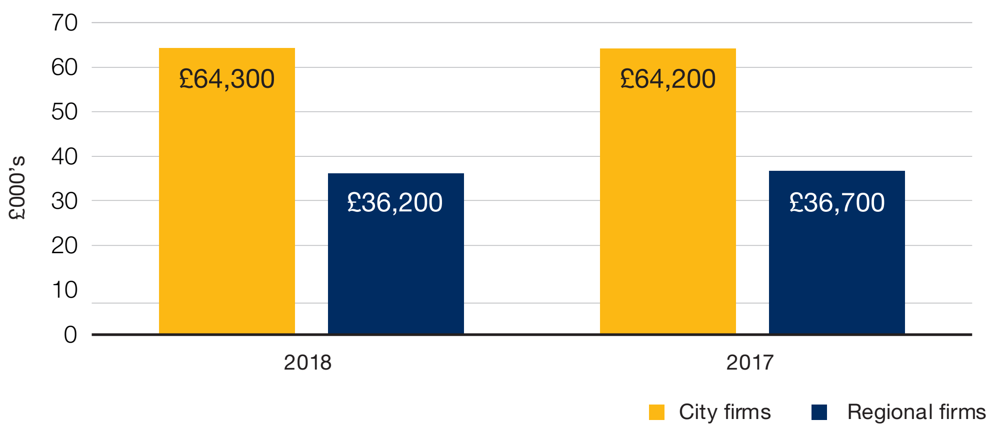
Increase in headcount – Aggregate across all participants



Staff costs as a percentage of fee income

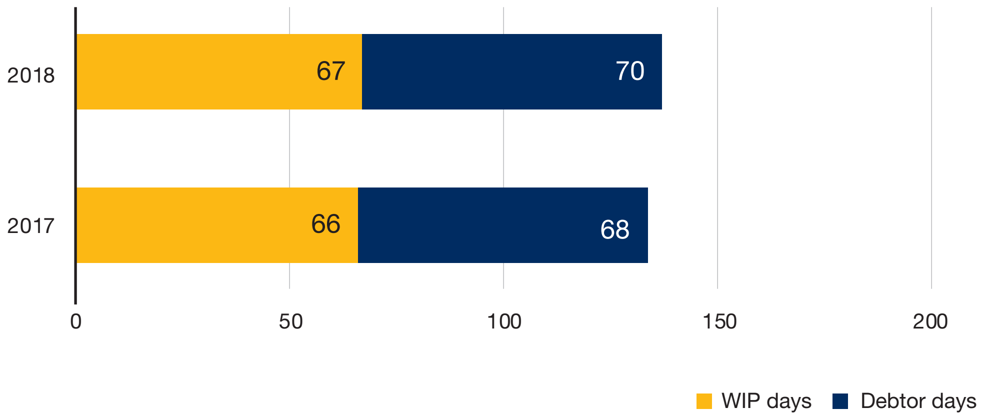


Average employment cost per head



Average lock-up days at year end
City firms

Average lock-up days at year end
Regional firms



City firms

City firms have experienced a more challenging year than in 2017, with 10% reporting a fall in revenue compared to 8% last year, though the proportion of firms achieving growth of more than 10% remained strong.

For those firms that saw an increase in turnover, 40% saw an increase of more than 10%, which is a jump compared to one third seen last year.

Overall however, City firms have seen a slowing in the pace of growth, with an aggregate revenue increase of 6.5% across all participants compared to almost 8% last year. This slowdown has clearly been felt by some equity partners as 35% of firms reported a fall in PEP. The wider story was more positive however, as the average PEP across participants increased by 8%.

In conjunction with the increase in PEP, we have also seen firms increasing headcount, especially among fee earning staff. This sends a clear message that partners are keen to ensure they have sufficient resources to meet future challenges and potential opportunities.

90%

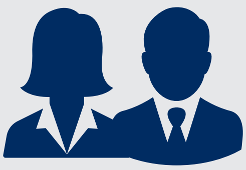
of firms experienced growth, but rate of growth slowed

Fees per fee earner remained

static

Average PEP increased by

8%



Total headcount increased by

6%

but equity partner numbers remained static

40%

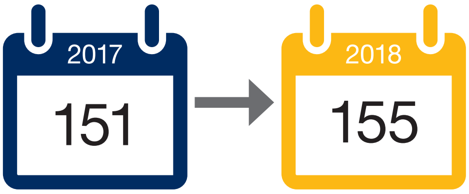
of firms saw growth of more than **10%**

Good news for City firms as professional indemnity insurance (PII) premiums fall

After a couple of years of unpredictability, average PII premiums as a proportion of fee income fell, albeit by a small margin, from 1.8% to 1.6%. The effects of this trend appears to have been quite positive with more than 45% of participants reporting a fall this year, compared to only 20% of participants last year. There has been a clear emphasis on firms to look closely at their risk management approach and perhaps this is feeding through to premiums. However, with recently reported instability in the PII market, it remains to be seen whether this trend will continue.

Increase in debtor days contributes to rise in lock-up

Lock-up continues to be a challenge for many firms, with average total lockup increasing to 155 days this year, compared to 151 days in 2017, and reversing the fall reported between 2016 and 2017.



While the value of time locked up in work in progress has remained static, it is an increase in debtor days that has given rise to this increase. It is important that firms do not become too relaxed about reminding clients about outstanding payments, and finance teams, fee earners and even partners need to appreciate that the process doesn't end with simply sending a client a bill.

City firms in particular should take note that they trail regional firms with lock-up management, especially the recoverability of debtors, with the gap widening to 50 days this year.

Brexit uncertainty

Fewer than 20% of City firms have changed their view over the impact of Brexit on the market. This year's survey saw only 6% of firms viewing Brexit as an opportunity, with the majority viewing it as posing a net threat to their business.

The regional view

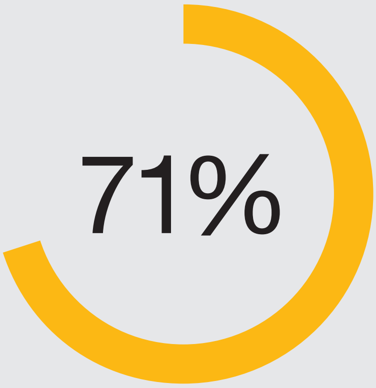
It is not just City firms that have had a challenging year, as almost 30% of regional firms experienced a fall in revenue, compared to 20% in 2017. However, of the firms that did experience growth this year, a slightly higher proportion compared to the previous year, saw an increase of more than 10%.

Like their City counterparts, equity partners in regional firms fared reasonably well this year, with a average increase in PEP of 6%.

The trend among regional firms has continued to reflect a challenging legal market. We note that last year was described as being somewhat sluggish compared to prior years and the proportion of firms experiencing growth of more than 10% remained more or less the same as last year.

This year's results reveal there is a struggle among firms to maintain market share with a higher proportion of firms experiencing falling revenues. Though overall, the aggregate rate of growth was better at over 6% this year compared to just over 4% last year.

As with City firms, a good proportion of regional firms reported positive movements in PII costs, with 50% seeing a decrease compared to last year. Firms of all sizes need to continue to proactively assess their risk and exposure to claims to handle a potential hardening in the market over the coming year.



of firms experienced growth, and aggregate growth was better than last year

Fees per fee earner increased by just over

2%

Average PEP increased by

6%

Total headcount increased by almost

4%

28%

of firms reported growth levels of more than **10%**

Equity partners benefit from a rise in PEP

This year, 64% of firms reported an increase in PEP, compared to 60% in 2017. Slightly behind the performance of City firms, the average PEP rose by 6%. This is ahead of the average regional increase of 5% seen last year. In the context of a higher proportion of firms seeing a fall in revenues, is this indicative of a trend amongst a smaller number of successful firms taking a larger proportion of the market share from their competitors?

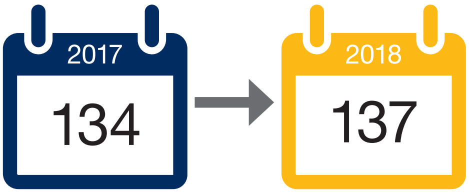
Despite a fall in revenue, regional firms continue to invest in staff

Regional firms continue to see staff of all types as being key to success, and total headcount increased by 3.7% in the year. At the same time, partner headcount only increased by 1.4% as firms focus on getting the staff/partner leverage correct.

Regional firms continue to invest in support staff, with non-fee earning staff making up 37% of the workforce. Although this is only a very moderate increase compared to 36% last year, we need to bear in mind that it is the regional firms that have struggled more to improve top line performance. Could this be an indication of a growing appreciation among regional firms of the value of retaining good quality staff as well as fee earners? It is perhaps too early to tell but it will be interesting to see how the emergence of AI over the coming years will shape regional firms' strategies and whether they will opt to invest more heavily in people or explore technology as an alternative.

Lock-up on the rise but still lower than City firms

Although regional firms have, once again, fared better than the City with lock-up, there has been an increase in average lock-up days, which now sit at 137 days compared to 134 last year. The profile also remains similar on a near 50:50 split between WIP and unpaid bills.



What lies ahead?

It has been yet another challenging year for all law firms, but the need for clear horizon scanning and risk management strategies remains as important as ever. Firms are still placing importance on their approach to staffing, but the emergence of artificial intelligence and the persistent uncertainty around Brexit is encouraging many to reassess their next steps.

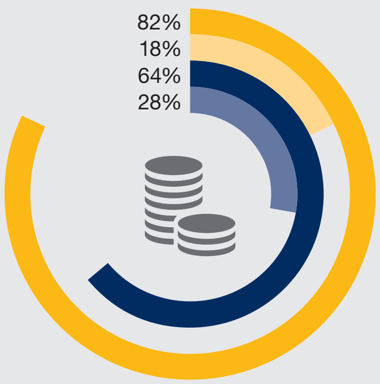
Recruitment of high quality staff

Last year, we saw regional firms place a higher emphasis than their City counterparts on recruiting and retaining high quality people. This year both City and regional firms are prioritising attracting and retaining top talent and cited offering clear progression and a market competitive remuneration package as two of the top factors for recruiting high quality staff.

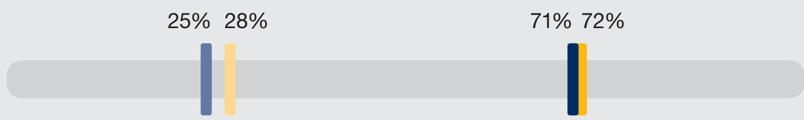
However, it is not just the tangible benefits that attract talent; in a market where staff like to retain fluidity with their career prospects, the importance of being associated with a well-regarded firm is strong. Firm reputation remains a priority for all with every participant identifying this as a key factor in attracting new recruits.

Last year, many law firms cited retention of high quality staff as being a critical factor for future success. How important are the following to your firm's strategy to achieve this?

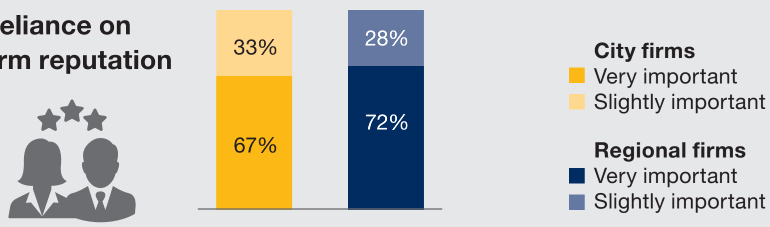
Remuneration package which is equal to market rate



Clear progression path



Reliance on firm reputation



Brexit uncertainty

Brexit remains a cause of concern for the industry with City firms being the most cautious of the potential outcome. 50% of City participants have not changed their view that Brexit represents a threat to their business, and only 6% view it as offering positive opportunities.

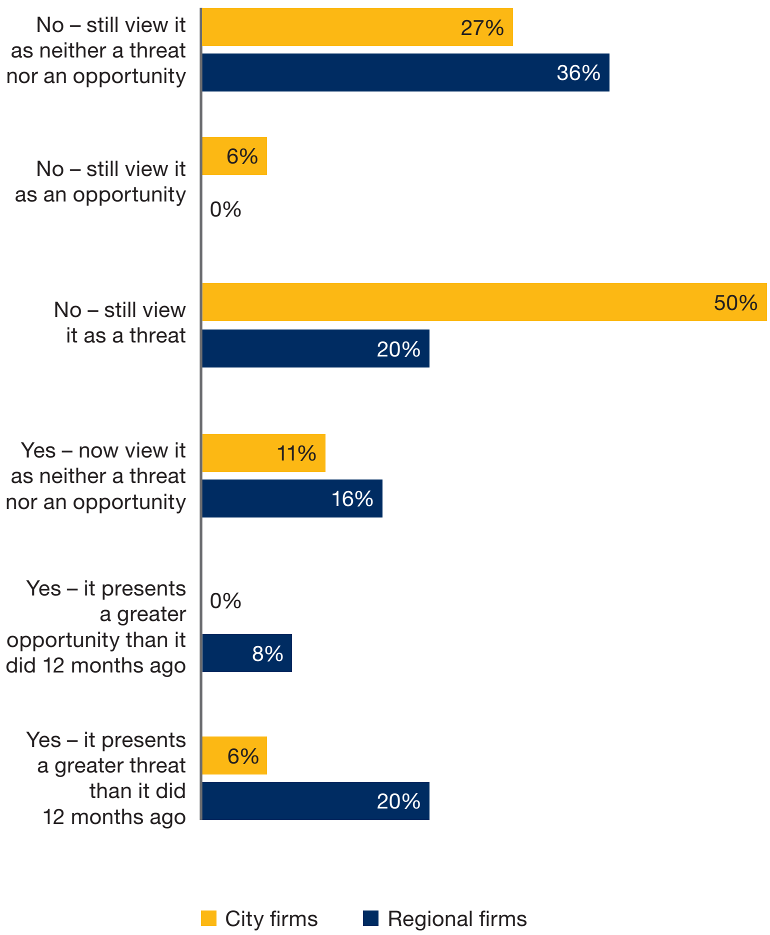
Regional firms are still relatively benign on the subject compared to their City counterparts, though a greater proportion are starting to become more nervous, with 20% of regional firms feeling that the business threat level has increased since last year.

Last year we noted that over a quarter of regional firms had not yet assessed the likely effect that Brexit would have on their business and were operating a 'business-as-usual' approach until the terms were agreed.

Unfortunately, uncertainty remains a key word among all our participants this year with many firms simply 'hoping for the best' and focusing on day-to-day operations due to the delays in Brexit negotiations.

The question for those firms taking a 'wait and see' approach is whether they will have sufficient resources and agility to take advantage of opportunities that arise or, indeed, be able to take decisive action to counter the threats that may follow.

Over the last 12 months, has your view of the risks/ opportunities presented by Brexit changed?



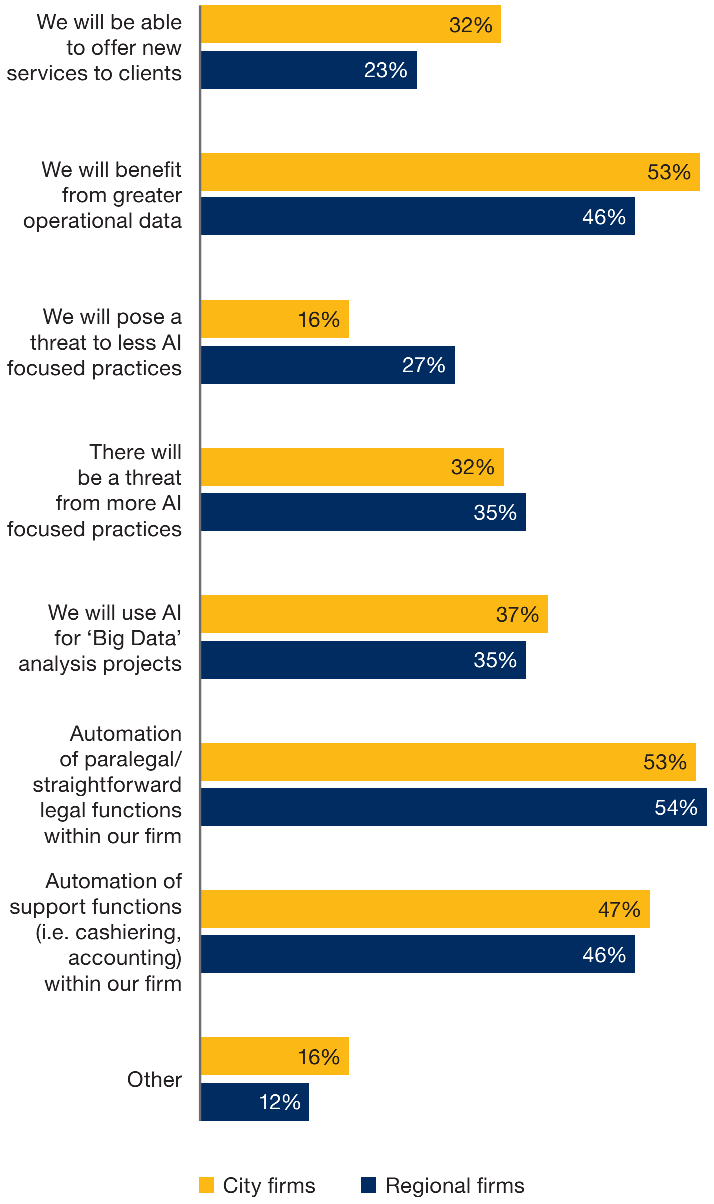
Artificial intelligence (AI)

A key factor that has gained momentum over recent months is the emergence of AI as a force for change in the industry, and this year we asked firms for their view.

Both regional and City firms were united in their views, with the majority seeing the benefits of automation as providing a way to streamline their less technical operational areas. A flow of higher quality operational data will help firms to focus on developing their core business, while also remaining competitive and financially stable. It is also encouraging to see a number of firms, especially from the regions, being proactive and taking steps now to put themselves at the front of the pack.

Although AI may be seen as a playground for the bigger firms (including all professional services firms), smaller businesses that can understand the potential now, will position themselves favourably in the market going forward.

Over the next 2–3 years, we think AI will impact on our business in the following areas.



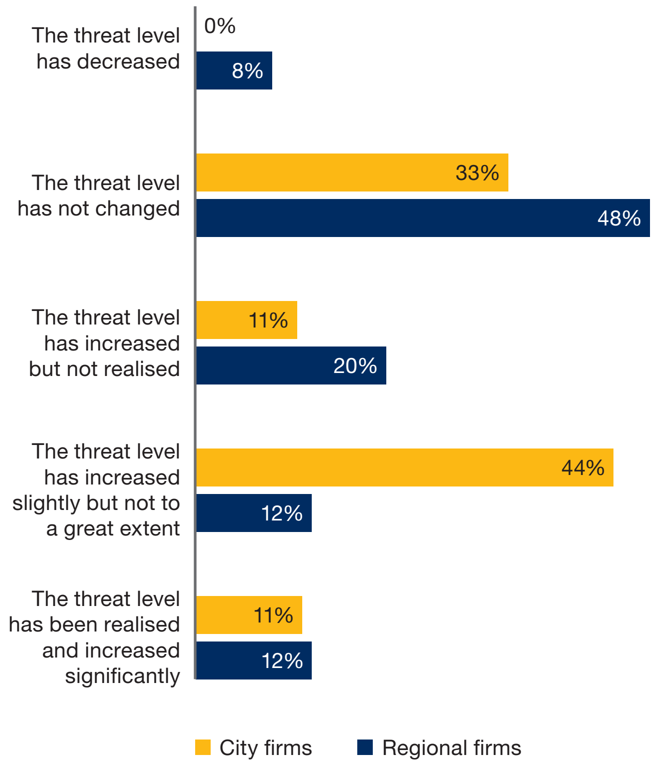
More than one answer could be selected.

Threat of non-lawyer firms

Last year, the threat to market share from other non-lawyer firms, was seen as a significant consideration for both City and regional firms. Indeed, we are already seeing accountancy firms making moves in this area.

It is therefore not surprising that the majority of City firms view the threat of non-lawyer firms as having increased over the past 12 months, though most to a relatively moderate degree. Given that the threat of 'supermarket law firms' didn't really materialise to the extent that many feared, perhaps firms are feeling more able to compete against new business models, indeed, the regional firms remain less wary. Time will tell, but we are seeing an increasing appetite for other professional firms to dip their toes in the water.

To what extent do you feel the threat of non-lawyers entering the legal market has been realised?



Pricing

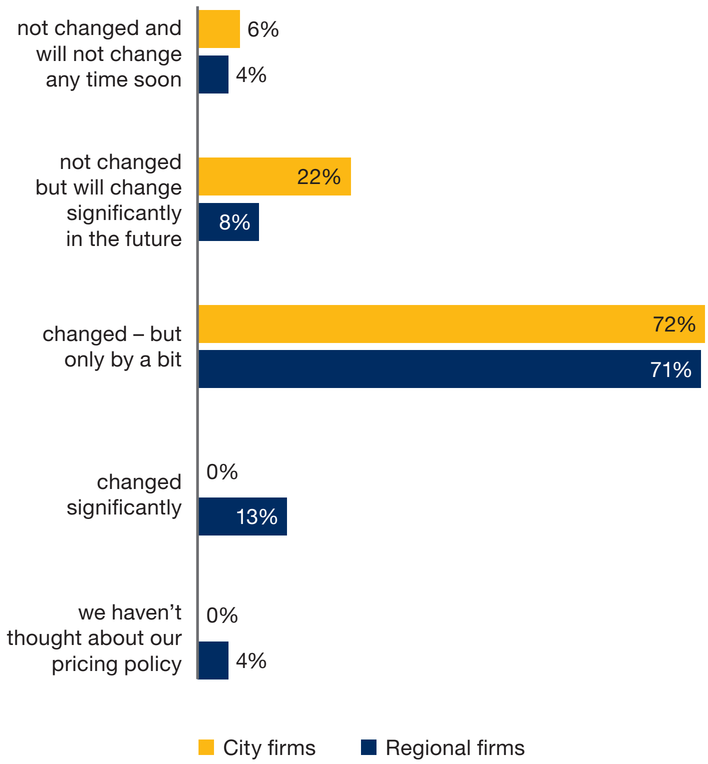
When facing all of these external challenges, it might be easy for firms to forget the need to monitor their internal operations, and so it is encouraging that the majority view pricing as being a critical success factor.

Almost 80% of City firms and 72% of regional firms cited pricing transparency as a critical success factor over the next few years and the SRA has made it very clear that open and transparent pricing policies will be an area of focus over the coming years.

It is not just the importance of getting the level of price correct to ensure sustainable profits, but also the need for transparency that is key here. The risk of getting this wrong, and appearing to be uncompetitive, cannot be understated.

Most City and regional firms have made some changes to their pricing approach over recent years, though change has been moderate rather than transformational. In any case, those that have not changed their approach, or have not thought about it at all, are in a clear minority.

Over the couple of years, the way we price our work has...



Our Professional Practices team

Whether a large multinational law firm or a small boutique practice, senior partners, managing partners, CEOs and executive boards are faced with the ongoing challenge of delivering sustainable, profitable growth in the face of ever-increasing competition.

At Crowe, we bring more than depth of expertise. We take a highly-accessible, collaborative approach associated with smaller accountancy firms and marry it with the technical expertise and reach of the largest firms. We offer international expertise coupled with local and personal delivery.

Our professional practices team advises law firms of all sizes on their growth plans, always tailoring our advice to best suit their needs.

How we help law firms

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- Business structuring advice
- Risk management including cyber security
- Regulatory compliance
- Business strategy and future planning
- Partnership tax compliance and advice
- Remuneration planning
- Global mobility
- VAT advice
- Outsourcing
- Law firm partners' personal tax
- Personal financial planning
- Ongoing training and support

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We are trusted by thousands of clients for our specialist advice, our ability to make smart decisions and our readiness to provide lasting value. Our broad technical expertise and deep market knowledge means we are well placed to offer insight and pragmatic advice to all the organisations and individuals with whom we work. Close working relationships are at the heart of our effective service delivery.

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