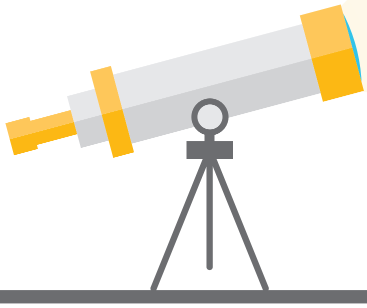
Law Firm Benchmarking 2019

Providing clarity in the legal sector

Contents



The big picture

Have macro-economic events dictated firms' results, or was it business as usual? Looking forward, what do law firms see as being business critical risks and where will they focus their resources in the coming year?

Against a backdrop of another 12 months of political and economic turbulence, this year's annual law firm benchmarking makes interesting reading.

The results of our benchmarking, which are based primarily on results from participants with financial years ending in spring 2019, provide a timely snapshot of UK legal market performance.

Revenue growth

The uncertainty created by Brexit and its associated political fallout is, of course, not new. This year, we see another steady performance, with aggregate growth across all participants falling back slightly to 6.5%. Looking beneath that headline growth figure we find very mixed results.

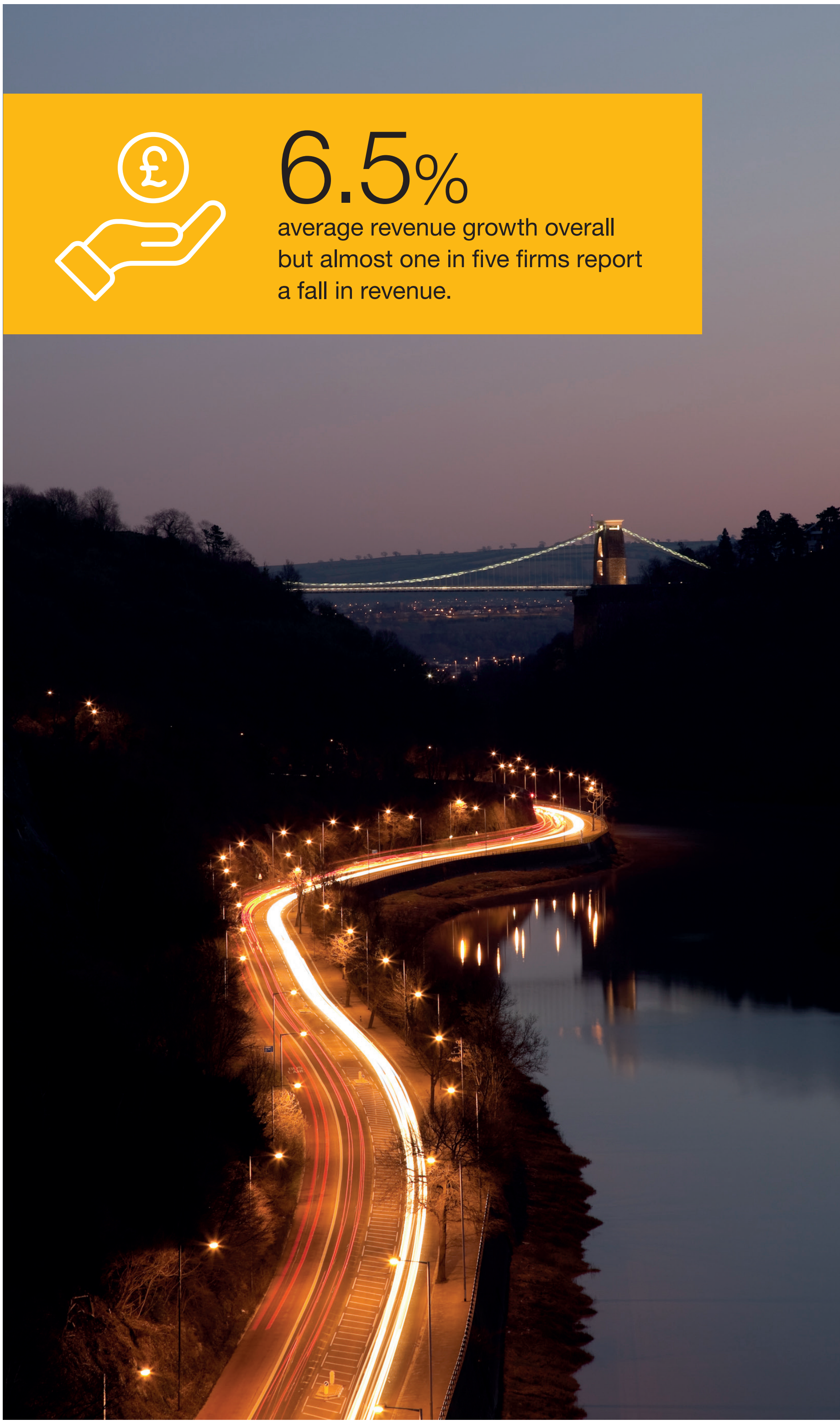
For some firms it has clearly been a challenging year, with almost one in five participants reporting a fall in revenue. As in previous years, it is the regional firms where we see the greater share of shrinkage, although the key feature this year is the proportion of city firms reporting a fall in revenue. This is now up to 17% from 10% in 2018 and 8% in 2017.

Are conditions ripe for further consolidation in the sector? More than a third of city firm participants think so, although this view is only shared by just over a fifth of the regional firm participants.

The market does appear to be hardening and, economically at least, it is difficult to see a significant improvement in the 2019/20 year. This is the view of many law firms, with 57% of participants stating they have a negative outlook for the UK economy in the coming year. City firms are generally more concerned than their regional counterparts.

Encouragingly, many firms still see opportunities ahead, with three-quarters of participants stating they either have a positive, or very positive, outlook for their firm for the coming year. Without doubt, law firms will continue to play an important role as the UK deals with the implications of Brexit; regulatory change is so often the catalyst which creates demand for professional advice.

It seems that firms are positive with good reason. The majority of participants grew their revenues and more than a third of firms achieved growth in excess of 10%. Regional firms generally achieved higher growth rates than seen in the City, which is a reversal of last year's position.



6.5%
average revenue growth overall but almost one in five firms report a fall in revenue.

Profitability
In aggregate, the firms in this year's benchmarking have increased their total profit pool by 9% but this masks some considerable variation between firms.

Over a third of participating firms suffered a fall in their total profit pool this year, with both city and regional firms impacted equally. On average, the decrease in profit for these firms was around 7%.

The good news is that for the firms who increased their total profit pool, just over two thirds did so by more than 10%. Interestingly, the biggest improvements generally came from those firms in the sub £20 million revenue band, most of whom are based outside of the City.

Profit per equity partner (PEP) levels appear to be under pressure. While regional firms have managed average PEP growth of just under 2.5% compared to 6% last year, the City average has remained static following on from the 8% increase reported last year.

Digging deeper reveals the pressure in the City with over 40% of the City firms experiencing a fall in PEP this year. It's not all good news in the Regions with just under 30% of firms showing a fall in PEP.

That said, for this year's participants, average City PEP of £413,000 continues to run at a level which is more than double that of the regional firms (£201,000).

People

This year, the number of firms growing their teams fell slightly to 64%, although it was the city firms who made the greatest investment in headcount, almost doubling that of the regional increase.

We still see only inflationary rises in fees per fee earner of 2.2% in the City and 1.3% in the regions. Either productivity gains remain stubbornly difficult to implement, or any gains made are only at a level that offsets price pressure from clients. For now, the model of 'more heads equals more revenue' still appears to be holding.

Salary pressure has cooled in the City this year, with the average cost per head only increasing by 0.9%. Compare this with the 3.7% average increase reported by regional firms and we can conclude there is still competition for talent in the regions. Holding onto your best people is a priority; more than half of participants identified retention of our key people as a business-critical risk, when only 29% of participants considered the availability of people with the right skills to be business-critical.

How are firms going to achieve this? With many firms planning to update their people development strategy, the answer appears to be flexibility; almost two thirds of firms plan to increase their level of remote, agile and virtual working in the coming 18 months.

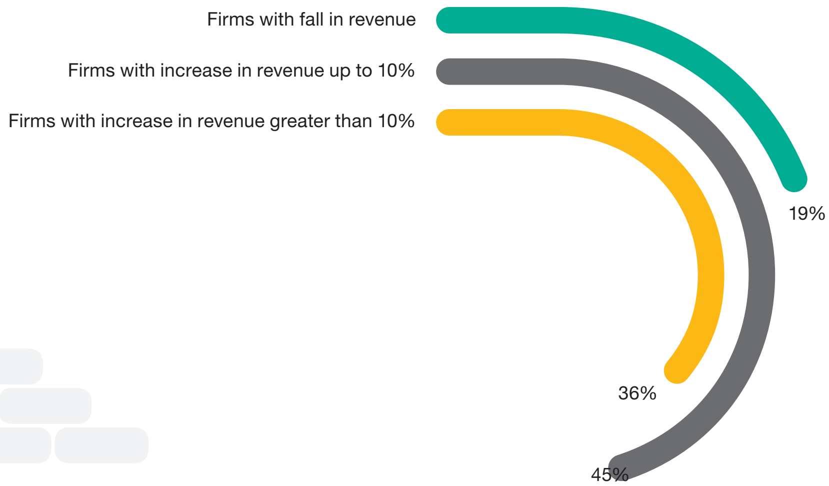
In the current environment, flexibility can be key to success. As shown this year, well-run firms can achieve profitable growth in an uncertain economic environment and the legal services world remains fast-paced, uncertain and challenging but still full of opportunity. Being adaptable, change-ready and quick to respond will no doubt be the key features of next year's most successful firms.

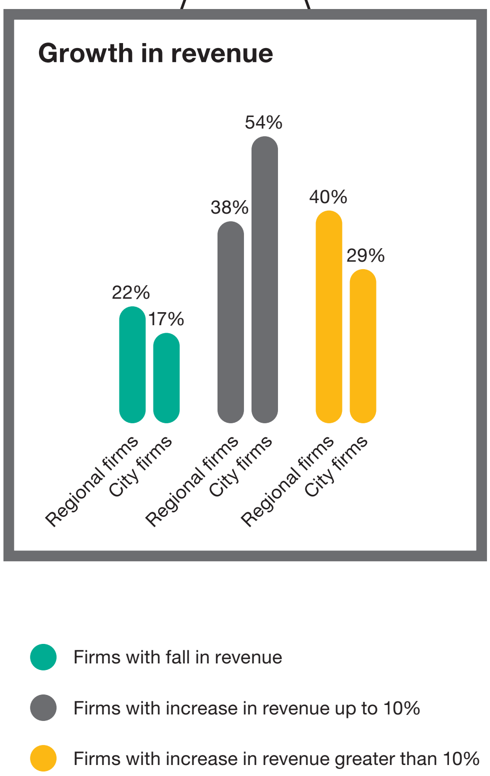
2018/19 highlights

This year's headline results show another year of steady performance. But look a little deeper and we find greater volatility in both revenue growth and profitability.

Revenue

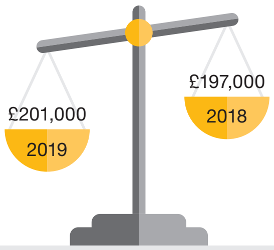
Change in revenue by overall population





Profitability

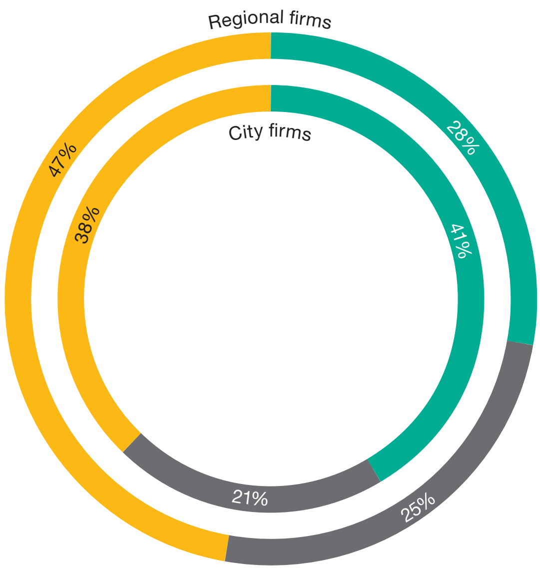
Profit per equity partner (PEP)



Regional firms

City firms

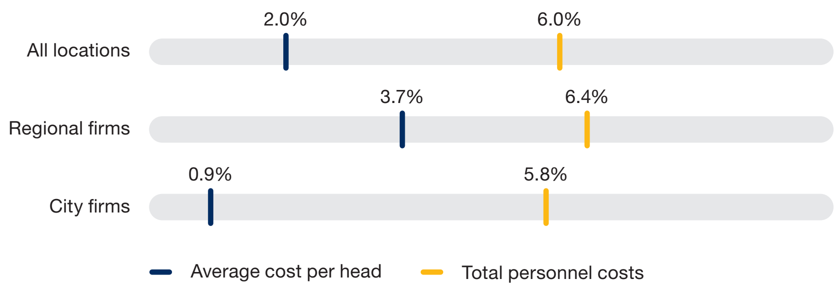
Changes in PEP



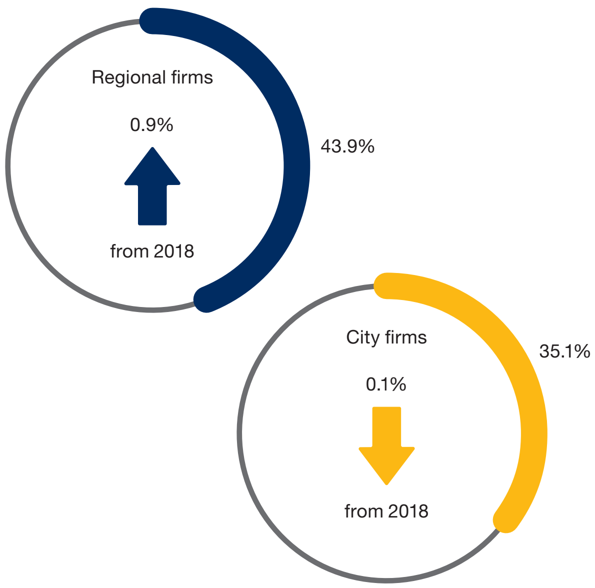
- Firms with fall in PEP
- Firms with increase in PEP up to 10%
- Firms with increase in PEP greater than 10%

People

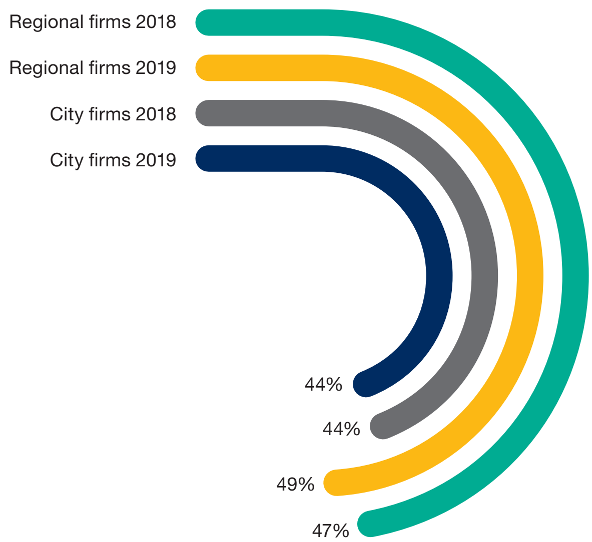
Change in personnel costs



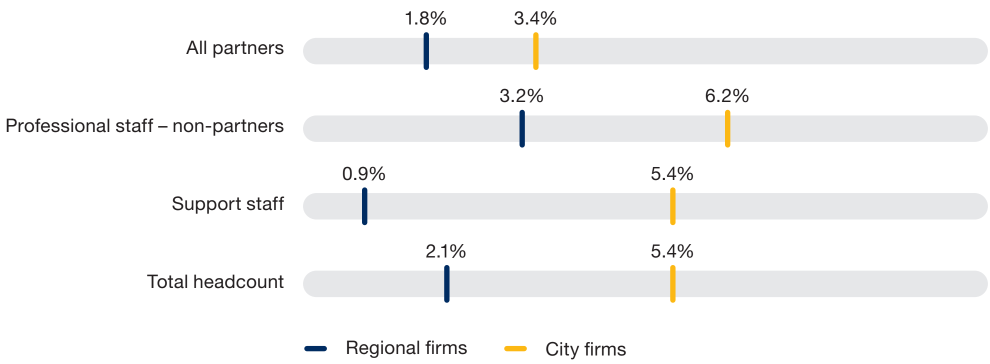
Average staff costs as a percentage of fee income



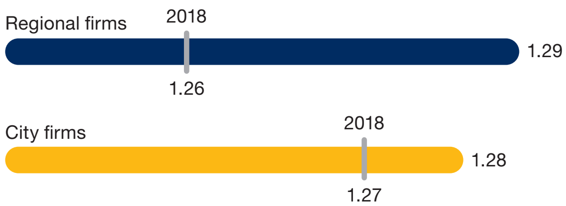
Percentage of top-tier partners



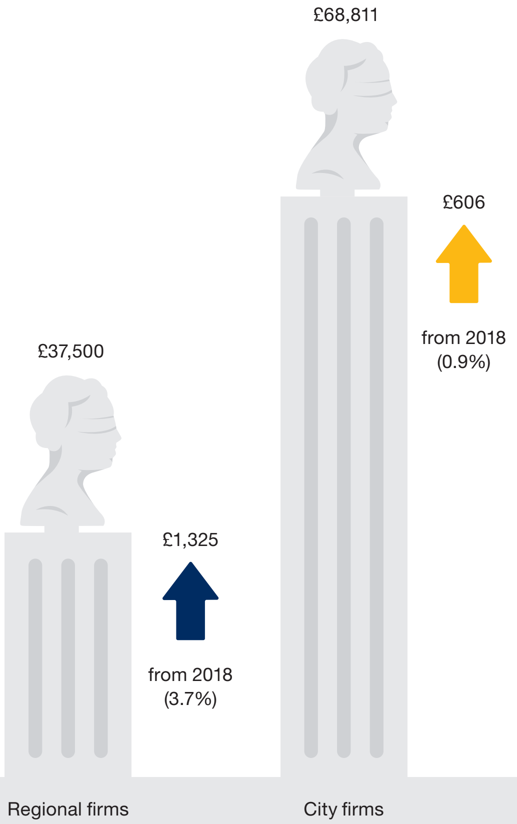
Increase in headcount



Fee earner to support staff ratio

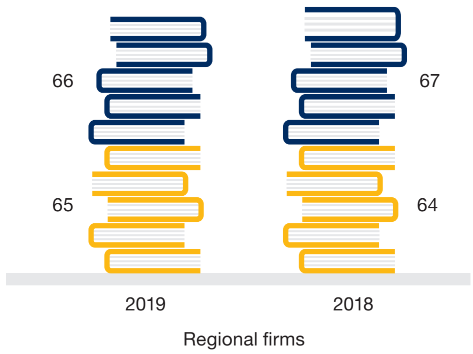


Average employment cost per head



Working capital

Average lock-up days at year end



City firms

It has been another competitive year in the City with the proportion of firms reporting a fall in revenue this year rising to 17%, up from the 10% we reported last year and 8% in 2017.

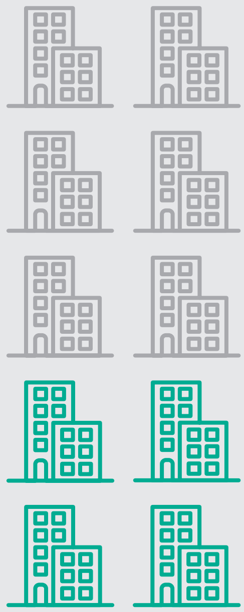
However, many firms grew both top line and bottom line and a 5.4% increase in headcount shows a confidence with firms continuing to invest in building their teams. Participants have clear plans to increase their level of agile, remote and virtual working over the coming 18 months and the loss of key people was reported as the primary business critical risk.

Almost one in six city firm participants reported a fall in revenue this year, with the average decrease for those firms being 7%. This proportion of contracting firms has been steadily

83%

of firms experienced growth this year compared to 90% last year.

4 in 10 of the city firms participating saw a fall in their all-partner profit pool and PEP. Median PEP remained static.



29%

of city firms grew revenue by more than 10%.

increasing for the last couple of years, so is the flat economy having a bigger impact and could this be indicative of an increasingly competitive marketplace?

With almost 30% of city firms still generating growth in excess of 10% and aggregate growth across all participants holding at 6.7%, our survey shows the legal sector is resilient and doing well despite the current economic uncertainty.

In terms of profitability there has been no real change in PEP this year. Median PEP for City firm participants remains static at £414,000.

However, drill down into the data and the results are more polarised; just over one in four firms saw a fall in their total profit pool and PEP this year, while just under one in four enjoyed PEP growth of more than 10%.

Even after taking into account those firms with a falling top line, or increase in top-tier partner numbers, there are some firms whose cost base has increased this year and other firms whose revenue growth is turning straight into bottom line profit.

5.4%
headcount increase.

The average employment cost per head increased by
0.9%

Average fees per fee-earner increased by 2.2% to
£252,275

In the coming 18 months,
71%
of firms plan to increase their level of remote, agile and virtual working.

The confidence to grow

While only 4% of city firm participants are positive about the UK economy for the coming year, 70% have either a positive, or very positive, outlook for their firm. Firms clearly see opportunities ahead.

There is certainly a confidence to invest in building teams. City firms added heads at a rate equal to at least double that seen in the regions, with a 6.2% increase in non-partner fee earners being the highlight. Investment in support teams followed closely at 5.4%, preserving the fee earner to support staff ratio at 1.28, slightly up from 1.27 last year.

Average fees per fee earner only rose at an inflationary 2.2%, suggesting either there continues to be little spare capacity in the system, or price pressure is capping any upside productivity gains. If client demand for instructions and transactions holds, there will continue to be a demand for good people. We don’t appear to be seeing any sector-changing benefits from advanced technology leverage just yet.

Controlled growth?

Although headcount grew, the associated staff cost has remained under control. The average cost per head rose just 0.9% this year and staff costs as a percentage of revenue remained consistent at 35%. This suggests that firms are currently mindful of personnel cost and are maintaining a cap as far as possible; creating leverage through the use of less expensive fee earners continues to be a common strategy for many firms.

1.6% Average professional indemnity insurance premium as a percentage of revenue remains consistent

Lockup is improving

All-firm average lockup has fallen by four days in total this year, down to 160 days, with a reduction of three days in the unpaid bills cycle. This is encouraging given the current uncertain economic conditions potentially impacting the cashflow of clients.

It’s all about workflow

Workflows and systems are high on the agenda for the coming 12 to 18 months. Seven in 10 city firms plan to increase their level of remote, agile and virtual working and around four in 10 plan to change their practice management and/or finance system and invest in advanced data solutions.

Future productivity gains will undoubtedly have technology solutions at their core and the effects on recruitment, training and development in the coming years will be interesting to follow.

Regional firms

In the current climate, we didn't expect a spectacular year but many firms will be pleased with this year's results, particularly equity partners who enjoyed growth in PEP. The increase in revenue was steady at 6% across all regional participants, but the proportion of firms who grew their top lines is back up to 78% – reversing a long-running trend.

This year, only one in five firms reported a fall in revenue. This is a reversal of what was a worrying trend in our 2018 benchmarking results, where 30% of participants reported a shrinking top line. The improvement is good news and is indicative of a year which many firms might consider to be a triumph over adversity. 47% of our participating firms enjoyed growth in PEP of more than 10%, and this in a period when the wider economic mood might have suggested a different story.

We suspect that firms have been mindful to control cost wherever possible and this, coupled with some stronger than anticipated revenue growth, has contributed to a healthy bottom line.

There certainly appears to be a level of self-confidence at the moment, with four-fifths of regional participants having a positive, or very positive, outlook for their firm for the coming year. This is notwithstanding that only one in eight participants shared the same view for the UK economy. Creating and capitalising on opportunities in tough economic times must be an open agenda item for many law firm boards and management committees.

78%

of firms experienced growth this year compared to 70% last year.

The regional all-firm aggregate growth rate was

6.2%

40%

of regional firms grew revenue by more than 10%.

The average employment cost per head increased by

3.7%

2.1%

headcount increase on average.

Average fees per fee earner increased by 1.3% to

£127,200

The all-partner profit pool grew by

8.4%

47%

of the regional firms participating increased their PEP by more than 10%.

In the coming 18 months, more than half of firms plan to:

- focus on cost reduction
- update their people development strategy
- increase their level of remote, agile and virtual working.

People retention rather than growth

Regional firms continue to invest in headcount. Total heads increased by 2.1% this year (3.7% in 2018), with a focus on building up the fee earner pool. This contributed to an average ratio of 1.29 fee earners for every member of support staff; up from 1.26 last year.

With fees generated per fee earner increasing by just 1.3% to £127,200, the demand for quality staff is still high as revenue remains closely linked to headcount. This demand is reflected in a 3.7% increase in the average cost per head; considerably higher than the 0.9% reported by participating city firms.

With retention of key people being a critical business risk identified by more than half of regional firms, it is no surprise that the same proportion plan to update their people development strategy in the coming 18 months and one in five plan to significantly increase their fee earner headcount.

2.5% No change in average professional indemnity insurance premium as a percentage of revenue

A changing partnership?

Total partner headcount increased by a modest 1.8% this year but splitting out the top-tier (senior equity) numbers makes more interesting reading. The aggregate all-firm number of top tier partners fell by almost 2%, with one in eight firms reducing the number of their senior partners.

This has a positive impact on PEP figures but the key question is whether this change is a result of natural retirements and succession or a planned move to a tighter control on senior equity.

Lockup – no change

All-firm average lockup has remained consistent at 131 days with no real change to the work in progress (WIP) and unpaid bills profile. This is encouraging and suggests that there is no sign of an increase in ‘slow paying’ creeping into the system yet. However, in the current climate it remains critical to mitigate credit risk by maintaining a prompt billing schedule and robust credit control processes.

Control costs and update remuneration models

Many regional firms will be looking closely at their outgoings in the coming 18 months as more than half of participants plan to focus on cost control. Boosting profitability will be a primary driver, but we suspect that building in some resilience in uncertain times will also be a factor.

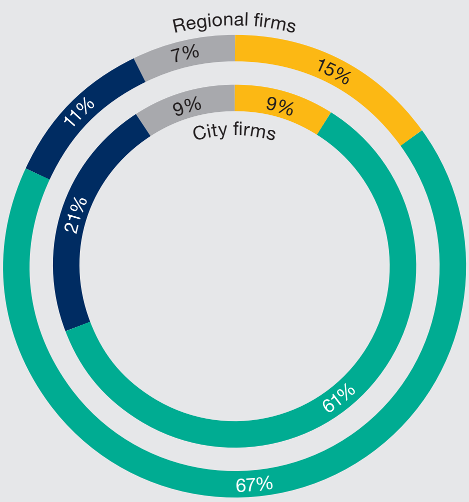
This extends to remuneration. Almost a third of firms are planning to change their partner remuneration model and more than a quarter plan to do the same with their employee remuneration and benefit structure. Balancing reward with motivation, performance and retention remains a priority.

Where next?

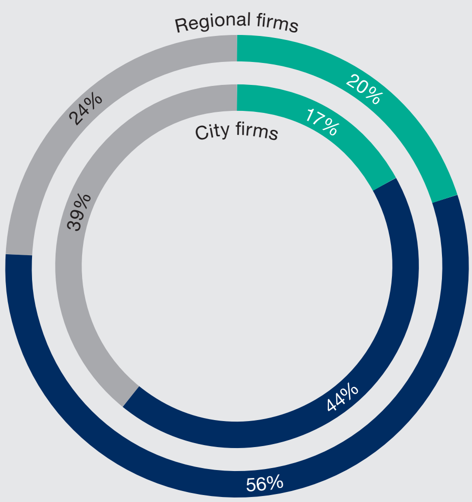
At the time of writing, the Law Society has estimated that a 'disorderly' no-deal Brexit could leave a £3.5 billion hole in the legal sector. Firms are clearly mindful of the wider economic and political conditions but are far more focused on 'controlling the controllable' than worrying about headlines. For now, it is all about managing current operational risks and adapting how teams deliver their work.

Participant's outlook for the coming year

For the firm



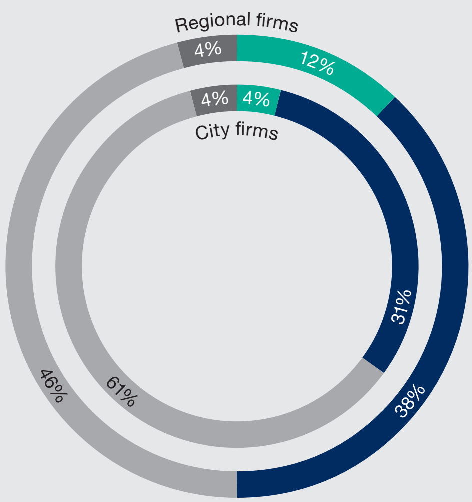
For the UK legal market



More than 70% of firms have a positive outlook for the next 12 to 18 months. This is set against a backdrop where approximately 90% of participant firms felt that the economy would either stand still or be more challenging and 80% of participants thinking the same for the legal market. It is interesting to see that firms are optimistic for their own future performance, but why could this be?

Is it because management teams believe the future will bring change which creates business opportunities that they can capitalise upon? Or is it that they are being optimistic that current economic uncertainties will become clear and they will be back to 'business as usual'? Perhaps they are simply confident that their firms are flexible and adaptable enough to meet future needs.

For the economy



Key

- Very positive – with new opportunities
- Positive – building on this year
- Neutral – consistent with this year
- Negative – business will be challenging
- Very negative – we are concerned

Business critical risks…

When it comes to the top three risks to their business, city and regional firms are in agreement on what matters most.

Top three business critical risks

Retention of our key people

52%

Cybercrime and fraud resilience

43%

Availability of people with the skills we need

29%

It is no surprise that retention of our key people is seen as business critical – your best people do more than deliver the work; they help shape the firm's culture, define its client service and provide innovation for future improvement projects.

Last year, firms reported that a clear progression path, market rate remuneration package and a strong firm reputation were all deemed very important to retain the best people. All of these remain 'must haves' but firms are also adding agile working into the mix. With a continued focus on talent retention, 28% of regional firms also plan to change their employee benefit structure in the coming 18 months.

Keeping track of the ever-changing threats from cybercrime and fraud continues to be a burden for all law firm leaders and the investment in both time and cashflow can be significant. However, this investment wouldn't be as significant as the impact of a serious fraud or data breach.

While many firms undertake periodic reviews of their digital hygiene, authorisation controls and data protection processes, the threats are fast-paced and criminals are becoming even more innovative. It is likely that the move to a live, continuous monitoring programme will become the norm for all firms in the near future as they try to stay ahead of hackers and protect themselves and their clients from loss.

Financial outlay here should be seen as an investment, not a cost. Visible, robust information and transactional security could easily become one of the defining factors for law firm clients when they choose their advisor.

> An average organisation should expect losses owing to fraud to account for between 3% to 6% of turnover, although in some cases it is as high as 10%.
>
> **Jim Gee, Crowe**
> The Financial Cost of Fraud 2019

…and the lower priorities

While the risks deemed to be business critical and higher priorities are as might be expected, there were a few surprising areas that firms consider a lower priority risk.

What is a lower priority risk for firms?

Threat of new market entrants

74%

Availability of funding

43%

Impact of Brexit

43%

Despite much commentary on the potential for emerging tech-based and ‘new model’ firms to disrupt the market, most firms considered this to be a lower priority risk, along with the availability of funding and impact of Brexit.

While these risks are heavily driven by external factors and not so easily controlled, it remains important for firms to undertake a degree of scenario planning to ensure they are prepared for those big, often unexpected, sector-wide changes which create huge opportunities or threats to the firm.

The new SRA Standards and Regulations

The Solicitors Regulation Authority (SRA) has now confirmed 25 November 2019 as the 'go live' date for its new regulatory model with a focus on simplicity, flexibility and improving access to law. There are a number of key changes, including:

- new Accounts Rules which are much simpler and more principles based
- separate codes of conduct for firms and individuals
- permitting freelance solicitors to provide reserved legal services
- allowing solicitors to carry out non-reserved work when operating within a business that is not regulated by a legal services regulator.

Are you thinking of using a Third Party Managed Account (TPMA) for your client money handling?

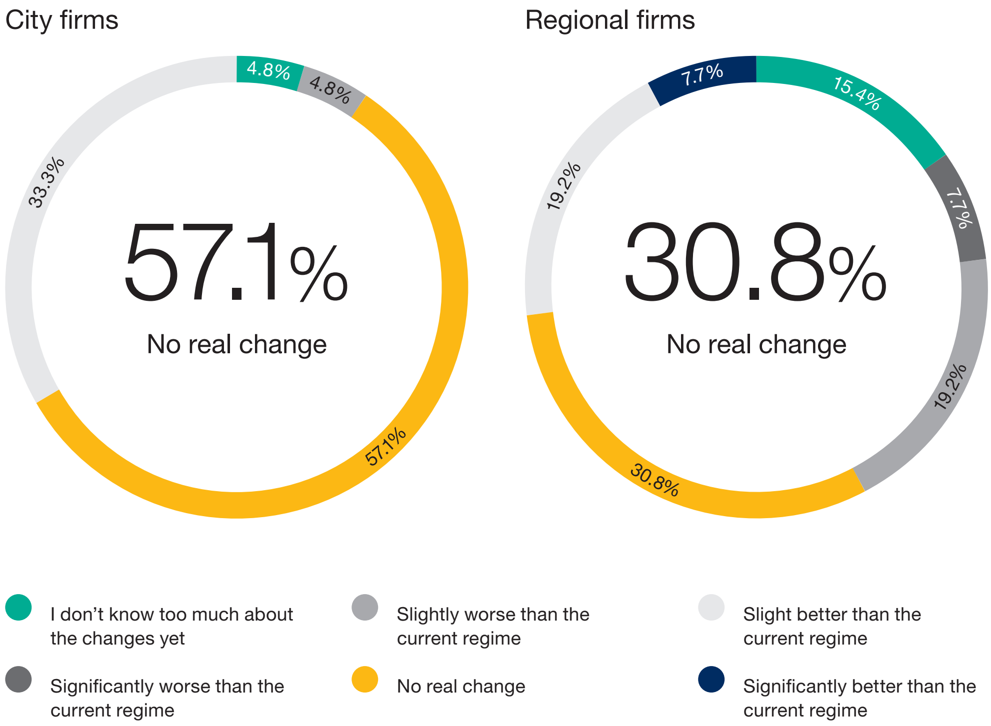
If so, you are in the minority against our sample. Not one of our participants is planning to use a TPMA in the coming 18 months.

There appears to be a difference of opinion between city and regional firms as to the benefits of the new regime. City firms view the changes to be minimal or a slight improvement on the current handbook, with fewer than one in 20 considering the new framework to be worse.

Regional firms are more polarised in their view; more than a quarter of regional firms view the new standards as worse or significantly worse than the current regime, but the same proportion see benefits and improvements.

Our view is that the new standards are evolution rather than revolution but do allow greater flexibility for those who choose to do things differently. The promised issue of more regular, timely and dynamic guidance by the SRA is likely to have a greater impact on firms as they will need to be able to respond quickly and demonstrate their resulting considerations and actions.

How do you view the new framework?



The biggest change to the provision of legal services in the UK will arise from...

City firms

37%
Consolidation in the market with far fewer firms taking market share.

21%
Increasing market share from other professional service providers (e.g. the Big Four accountants).

16%
Start-up firms with a focus on technology-driven service.

Regional firms

21%
Consolidation in the market with far fewer firms taking market share.

21%
Unregulated law firms.

21%
Start-up firms with a focus on technology-driven service.

Catalysts for change in the UK legal market

The new SRA Standards and Regulations permit much more flexibility for solicitors to operate outside of the traditional SRA authorised firm, for example as freelancers or within other professional services firms. It is interesting to note that firms do not currently view this as something that will have a big impact upon the sector.

So what do law firms think the future holds? The answer is that there is no clear view.

Just over a fifth of regional firm participants think the biggest change will come from consolidation in the market, and this proportion rises to 37% of city firms. In our experience, there is greater activity and more merger conversations than there has been for quite a while, particularly amongst smaller firms who are dealing with succession planning.

When it comes to competition, city and regional firms identify different forces for change. A fifth of city firms believe the Big Four accounting firms and other professional service providers taking market share will have a marked impact on the sector. Contrast this with the one fifth of regional firms who see the rise of unregulated law firms as being a bigger cause of disruption.

The near future – areas of focus

Over the next 12–18 months, we plan to...

City firms

71%
Increase our level of remote/virtual/agile working.

43%
Change our practice management and/ or finance system.

38%
Invest in advanced technology solutions (artificial intelligence (AI), document automation, data analytics).

Regional firms

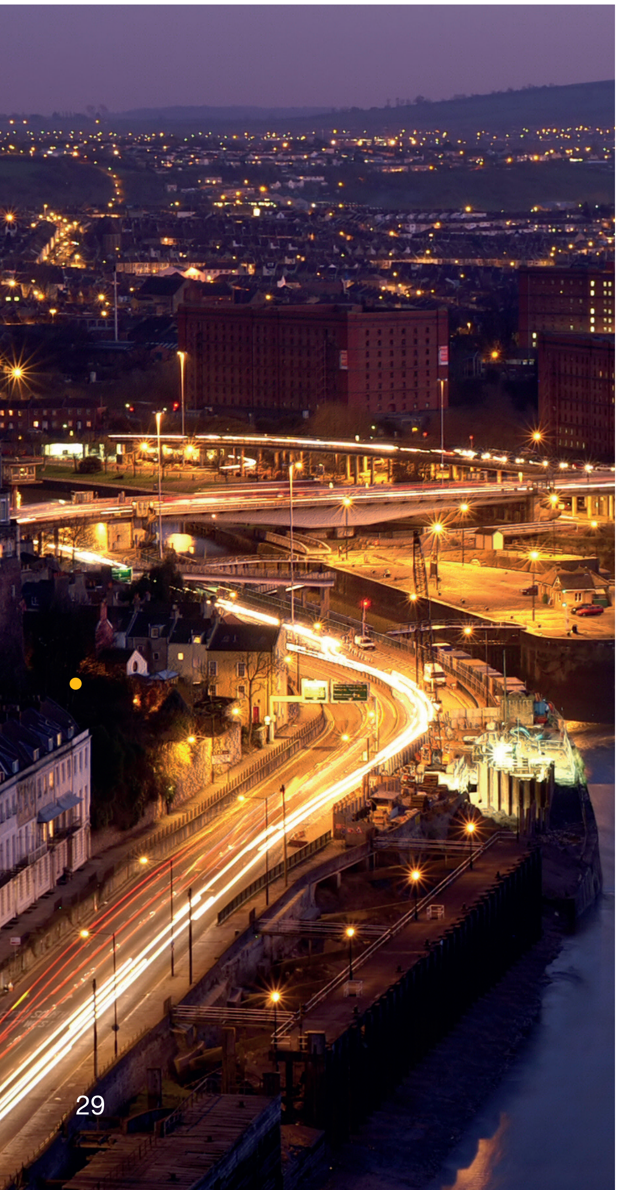
60%
Increase our level of remote/virtual/agile working.

56%
Focus on cost reduction.

52%
Update our people development strategy.

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

Financial reporting and assurance

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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