Hoffman Alvary First Report on 2016 and 2017

~ January 26, 2017 ~

> **66 Respondent Firms, including**
> - 28 *AmLaw 100* firms
> - 26 *AmLaw 200* firms
> - 12 smaller firms
>
> **PPEP of over $3M to under $500K**

Results. Over the past week, Hoffman Alvary polled the leaders of major firms across the US for an early look at 2016 outcomes and prospects for 2017. As always in this quick-look survey, our questions were narrow and focused on the numbers; our follow-up conversations and ongoing work with scores of firms during the year enable us to interpret these outcomes more broadly. Sixty-six firms responded to our inquiry, and despite their often uneven experience during the course of the year, more than three quarters (77%) report an increase in profits per equity partner (PPEP) over 2015.

> **77% of Firms Increased PPEP**

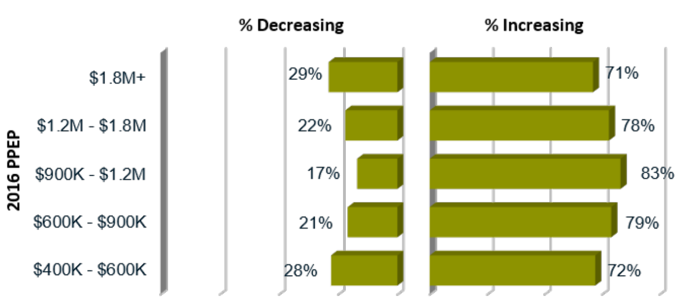
Perhaps more notable, however, is the ongoing tension between busyness and earnings. Twenty-three percent of firms reported decreases in revenue from 2015, although we know of no firm in the group that was seeking lower revenue or diminished productivity. Revenue increases continue to be driven largely by billing rate increases, and all responding firms reported raising partner billing rates for 2017. (In an effort to be quick and easy we only ask for partner rate changes, not those of other lawyer titles.) Sixty percent of firms reported raising partner rates between 2.5% and 4.5%, with the highest earning cohort pushing rates 6% or more. One has to wonder if rate increases are tone deaf in light of client demands, or if they are essential to surviving discount pressures.

Firm leaders' expectations for 2017 are cautiously optimistic. Sixty-eight percent anticipate increases in both revenue and PPEP, while 86% expect to manage their way to flat or higher PPEP. As the US economy continues to expand slowly, most firm leaders tell us they expect more work arising from Trump Administration policy changes. Despite this, increased in-house competition, fee pressures, continuing softness in litigation, inroads by LPOs, the unknown implications of Brexit, and increased tensions around world trade put a pall over some expectations.

2016 saw PPEP volatility across all categories of firms.

Since the Great Recession, firms in the highest average PPEP ranges have enjoyed the most unbroken increases in average earnings for their equity partners. This has been due in part to the strongest players enjoying returns to busyness earliest after recessions, to the increased impact of brand strength in competitive markets, and because these firms have managed their equity ranks carefully. That said, 2016 saw meaningful changes in PPEP in all firm strata.

Change in PPEP 2015-16 by Earnings Group



Distribution of Firms by Change in PPEP 2015-16

2016 Revenue Range	Down 5% or More	Down 1% - 5%	Flat +/- 1%	Up 1% - 5%	Up 5% or More
$650M+	8%	25%	17%	25%	25%
$325M - $650M	0%	6%	25%	50%	19%
$150M - $325M	26%	5%	11%	21%	37%
$90M - $150M	0%	9%	0%	55%	36%
$55M - $90M	0%	29%	0%	43%	29%

Large firms do not always win, although scale can certainly help. The chart to the left shows that all sizes of firms had access to a very good year. The decision to adopt the $180K associate salary scale put pressure on margins, especially those aspiring to keep pace with the highest-earning firms. Among firms with PPEP ranging from $600K to $1.2M, 75% of those who met the $180K scale (in some or all offices) were still able to increase PPEP year over year.

It is troubling to see a quarter of firms with revenue of $150M to $325M with PPEP declines over 5%. For most of these firms it was a single-year decline and not an historical trend, but these are also the firms looking at 2017 with less optimism than their larger peers.

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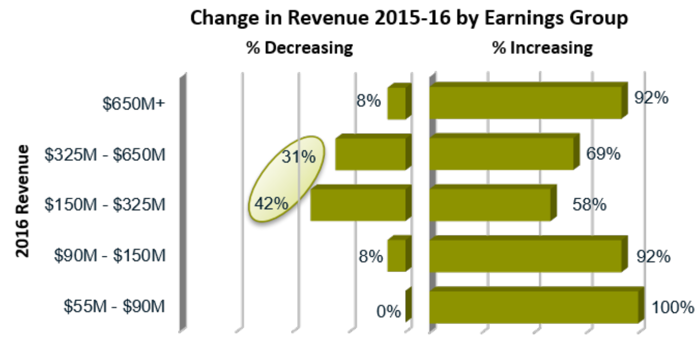
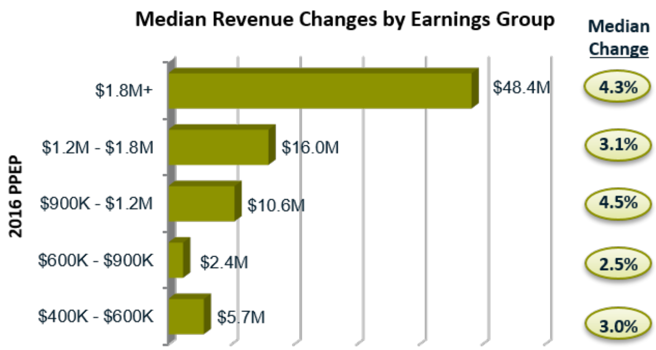
While most firms had an up year, firms in the "Big Middle" were more likely than others to struggle with revenue. Firms in every size and prestige category experienced both strong and weak outcomes for the year, but 37% of respondent firms with revenue between $150M and $650M (roughly corresponding to the *AmLaw 50* to *150*) saw their revenues decline year over year. Some in this middle range are looking to compete with elite firms for the best work by offering pricing advantages. Their successes, however, are more strongly linked to their scale and recognition in niche sectors as effective offsets to smaller participation in capital markets and, for some, the limitations of a weaker regional economy.

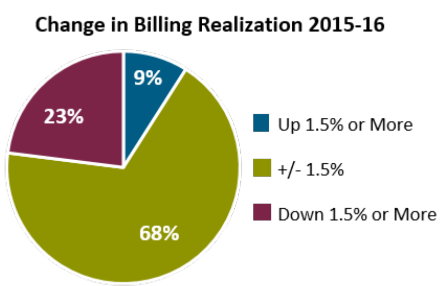
Smaller end firms that participated in our survey tend to be more focused than smaller firms generally, and compete on a different model from much larger firms. Their niche credibility allows them to "hit above their weight" with pricing, while maintaining the advantage of overhead and associate compensation that need not keep pace with the elite. It bodes well for the long-term health of the profession to see a large majority of these firms having experienced a strong year.





It remains to be seen whether a niche strategy is sufficient protection from the forces of scale. Maturing industries, including the legal profession, are subject to the cascading effects of market share begetting market share. Revenue changes by earnings group show that, once again, the highest earning firms have grown the most new fee revenue since the prior year. Their median gain of $48M, shown to the left, was eight times that of firms earning between $400K and $600K. This is notable amid a market landscape of uncertain demand characterized by shrinking outside legal budgets.

2016 billing realization held fairly steady for most firms. As shown in the pie chart, 68% of firms saw movement up or down within 1.5 points and most of these firms held realization changes to within a half point.

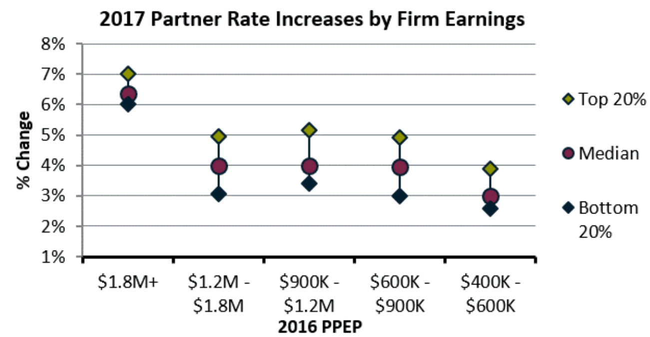


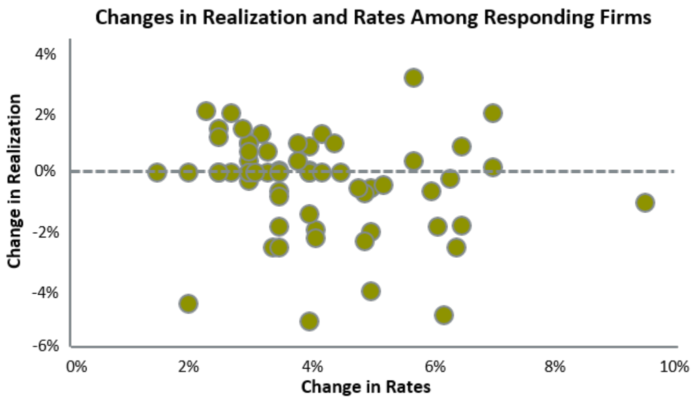
Distribution of Firms by Change in Billing Realization

Firms with PPEP	Down 1.5% or More	Down 1.5% - 0.5%	Flat +/- 0.5%	Up 0.5% - 1.5%	Up 1.5% or More
Up 5% or More	26%	11%	32%	16%	16%
Up 1% - 5%	17%	17%	54%	8%	4%
Flat +/- 1%	25%	0%	50%	13%	13%
Down 1% - 5%	38%	13%	25%	25%	0%
Down 5% or More	17%	0%	17%	50%	17%

PPEP gains and losses occurred among firms with all levels of realization experience. These outcomes suggest that while discounts and fee erosion are important issues in all firms, their impact is dwarfed by the larger effects of busyness, absolute rates and matter size. Much has been written recently about the end of the billable hour in pricing. We find that true alternative fee structures continue to account for less than 15% of revenue in most firms. Regardless of the price construct, realization remains an essential measure of opportunity cost.

2017 approaches to partner rates show a widening price chasm between cohorts of firms. Absolute partner rates tend to map closely, although not perfectly, with overall revenue and earnings. Bigger, more lucrative firms have bigger rates. As shown to the right, this group raised their rates the most aggressively and consistently, thereby extending the already significant gap in rates between cohorts of firms. Half of the largest firms and 71% of those with PPEP over $1.8M opted for increases of at least 6%, with none under 3%. By contrast, no firm in the smallest or lowest earning cohorts increased partner rates over 5%, from what were already, typically, much lower absolute rates.

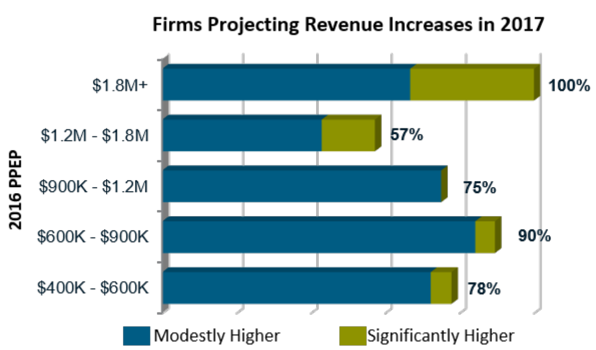


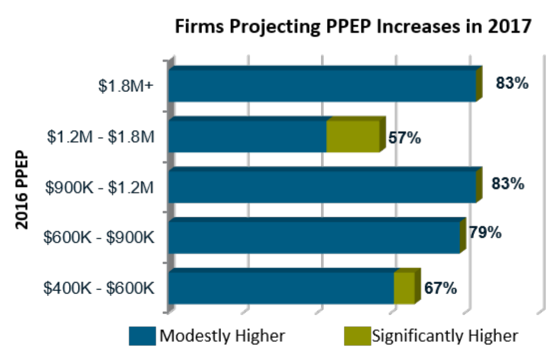


Changes in 2016 billing realization appear to have had little effect on 2017 rate changes. One might expect firms with decreasing 2016 billing realization to have posted the more modest 2017 partner rate increases. The scatter chart to the left shows the absence of correlation between firmwide realization and rate setting.

2017 outlook. Firms are more bullish on revenue than PPEP for 2017, with 80% of participants projecting increased revenue compared to roughly 70% forecasting increased PPEP. Viewed by size cohort, the most confident firms appear to be the *AmLaw 50* tier, all of which predict a combination of increased revenue and flat to increased PPEP. Firms in the *Amlaw 50* to *100* tier see the largest challenges for revenue growth, with roughly half projecting increased revenue. A third of those in the *AmLaw 151* to *200* tier forecast lower PPEP in 2017.

Switching to a view by earnings, the firms in the highest band all project increased revenue and flat to increased PPEP in 2017. Firms in the $1.2M to $1.8M earnings band view 2017 through a more modest lens, with only 57% projecting increased revenue and 28% projecting lower PPEP.





Most firm leaders anticipate increased productivity in corporate, real estate, healthcare and life sciences, while mixed in their views on intellectual property. Litigation continues to be a challenge with bright spots in specialized areas. About a third of firms expect bankruptcy and labor & employment to decline in 2017.

General commercial litigation continues to be regarded as the most significant productivity challenge. In this environment, many firms struggle with how to obtain more work for their general commercial litigators who may comprise as many as a third to a half of all litigation partners. Marquee litigators provide distinctive trial skills and are a draw for new matters, but even very large litigation departments regard only a handful of their members as having achieved this level of prestige. Everyone else, it would seem, needs to "pick a major" so that a crowded market will find their depth of experience relevant. We note that many of the same litigators who want to remain generalists prefer topical focus and reputations in the laterals they seek.

Top clients continue to drive earnings in firms of all sizes and market positions. As we reflect on why firms fare so differently every year, we continue to find a longstanding predictor: firms with the strongest gains in fees among their top 100 clients tend also to experience the strongest gains in PPEP. We are not advocating heavily discounted incremental gains in undistinguished revenue. Rather, when the top 100 fee relationships as a whole merit Board-level awareness, they typically bring strong matter profitability and reputational luster, in turn improving the firm's ability to attract and retain high-quality lawyers. We find that firms of all sizes can aim for Board-level relationships; the largest transactions for very large companies may require big firms, but smaller firms can still achieve Board-level relationships serving mid-market companies or larger companies through niche practices. In law firms, the 80/20 rule is much more like 90/10. In many firms the top 100 clients provide more than 50% of total firm revenue, and yet there are thousands of clients still to go on the firm's conflict list. Firms that have successfully persuaded their equity partners that attention to the 100 most significant clients, and the next 100 as the firm's farm team, reap professional as well as economic gains - further revenue, increased collaboration among partners and better likelihood of doing innovative and sophisticated work that results in market-distinctive expertise.

Diversity in the spotlight. 2016 brought greater focus on improving diversity in the profession. The American Bar Association passed Resolution 113 in August urging firms (and corporations) to expand opportunities for diverse attorneys at all levels. Resolution 113 was strongly supported in early September by an open letter from twenty Chief Legal Officers at significant Fortune 1000 companies. Despite the myriad benefits of diversity, firms continue to fall short in recruiting, retaining and promoting diverse attorneys. Firms have been revisiting their recruiting processes, hiring diversity leaders and strengthening diversity committees, but even with these efforts many firms continue to lag their diversity goals. We have observed at least one action that appears to drive improving diversity outcomes – sponsorship. In many firms, individual attorneys have little developmental support beyond generalized practice group services and lip-service mentoring, unless they are adopted by important partners. Diverse attorneys are less likely to be so adopted. Sponsorship matches diverse attorneys to specific partners. Sponsorship is more proactive than casual mentoring, providing career development advice and opportunities for substantive assignments and roles, client exposure, business development and leadership. Firms that embrace sponsorship do a better job of ensuring that their diverse lawyers have the professional experiences they sought upon joining the firm.

Many firms have recently changed their structural approaches to equity partner retirement. In recent years we have noted many firms' over-reliance on revenue associated with partners over age 60. This past summer, we conducted an in-depth study of 30 major firms' handling of the glide path toward retirement. Firms in this study had median PPEP of $1.1M and over 600 lawyers. Fifteen of the 30 firms made significant changes in the past five years, some in direct response to the lawsuit filed by the EEOC against Sidley Austin in 2005. Today, 14 of the 30 have a mandatory retirement date, with the most common age limits between 65 and 68. However, in all but one of these 14 firms, equity partners may continue to practice law at the firm outside the equity ranks after their "retirement," with permission from the Executive Committee. Such permission is rarely granted in half of these firms, but is commonly granted on a year-by-year basis in the others. We are not surprised to find fewer and fewer firms with strict departures based on age.

Permission to Continue Practicing After Leaving Equity Status

Option	No. of Firms
Yes	23
Largely at the partner's preference	16
Rarely	4
Limited to 3 years	1
Unpaid only	2
No, no longer insured	6
Equity Partners taper off gradually	1

We did find surprising the range of self-described firm successes and failures in transitioning clients as part of pre-retirement planning. Several firm leaders viewed even the potential to transition opportunities as overblown with most efforts regarded as futile, while others have found considerable success in even relatively new programs. The difference appears to lie in the firm's longstanding culture of partner "ownership" of clients and the extent to which top leadership participates in formal transition processes. Nearly every managing partner noted with some dismay that there are limits to legislating to achieve effectiveness. Transitioning partners' desires to play along trumps the firms' structures and approaches. For nearly their entire careers, individual partners' personal interests and those of their firms are well aligned. In transitioning to retirement those interests diverge. Nonetheless, eleven of the 30 firms now have formal "step-down" programs, generally initiated two to three years before intended retirement and overseen directly by management.

No surprise, even more firms are considering mergers. In 2016 our firm advised on three completed combinations (Arnold & Porter/Kaye Scholer, Fox Rothschild/Oppenheimer and Husch Blackwell/Whyte Hirschboeck)* and nearly twenty potential combinations that either terminated or are still under consideration. Notably, these potential mergers include firms at all earnings levels, market positions and geographies. Among the US/US discussions, the most common defensive reasons smaller firms seek mergers include succession issues surrounding their top rainmakers, in-house counsel panels favoring larger firms' capabilities and the more profound shifts of US economic activity toward money centers. Some large firms, even those that may have previously eschewed mergers, are finding the tally of growth goals by area of law, industry and office sites is unlikely to be met by laterals alone. Some of these firms have concluded, paradoxically, that they are more likely to gain quality and cultural fits with an entirely separate firm than with scores of one-off additions adopting their culture.

** Cited with permission from the firms.*

Thorny merger questions we're often asked – *And quick answers*

Why not keep separate profit pools for a period of time to mitigate earnings dilution for the more profitable legacy firm? *Not generally successful. This is anti-integration and challenges further growth.*

Can we cordon off their unfunded retirement program? *Not usually. Unfunded plans require new members to fund ongoing payments. Other solutions are needed.*

Do differences in firms' "Economic Balance Sheets" lead to term sheet adjustments? *Only very large differences merit adjustments; more often, big differences reflect incompatible philosophies about debt and infrastructure that preclude a combination.*

Should a merger of two large firms begin with inefficient, sometimes doubled-up, management positions? *Sorry, but yes. The first year of a merger is about commitment more than efficiency. This is not the time to disinvite key partners from management who should be serving as enthusiastic ambassadors. Years 2 and 3 are for streamlining.*

Are there covenants we can use that will prevent the target's strongest partners from jumping ship after we combine? *Some restrictions can be modestly helpful, but we have not seen any restrictions that incoming partners would sign that actually match the risks and liabilities undertaken by the larger firm. We know of no substitute for personal assessments of the target firm's key partners' intentions.*

Should we retain a third party branding expert to pick the new firm name? *You can, but it usually works only if the branding firm already understands the market positions of each firm since no one typically permits real-time research or testing. Inability to resolve this within the deal teams often predicts ongoing decision making challenges.*

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