MPF FEATURED REPORT

IS THE MARKET FOR MID-SIZE LAW FIRMS FINALLY STABILIZING?

by

Thomson Reuters Peer Monitor

October 30, 2014
For the past few years, mid-size law firms---like other firms across the market---have struggled with the challenges arising from the economic downturn that began in 2008. Unlike their larger firm counterparts, however, mid-size firms have found it somewhat more difficult to turn the corner in terms of their financial performance.\(^3\)

The results for the first half of 2014, however, suggest that we may be starting to see some stability in the mid-size market, even if that improvement remains fairly fragile.

Chart 1 sets out the key performance measures for mid-size firms as of the end of July 2014. As can be seen, on a YTD basis, the overall demand for the services\(^6\) of mid-size firms declined by 0.6 percent as compared to YTD July 2013. That decline was, however, considerably less than the year-over-year decline of 2.7 percent measured at the end of last year.

And, as compared (on a month-to-month basis) with July 2013, there was actually a modest increase in demand (of 0.3 percent) in July 2014, the second consecutive month in which such positive demand growth was achieved.

This improved demand picture was reflected in a noticeable uptick in average fees worked,\(^5\) which increased 2.2 percent over YTD performance in July 2013, and which compared quite favorably to the -0.7 percent decline in average fees worked measured on a year-to-year basis at the end of 2013.

Worked rates\(^6\) among mid-size firms continued to grow in the first half of 2014 at about the same rate as during 2013, and productivity\(^7\) (which has been a persistent problem for firms of all sizes) continued to lag.

During the first half of 2014, however, in sharp contrast to the preceding year, mid-size firms began to grow again in terms of their average number of lawyers, showing a 1.7 percent growth rate on a YTD basis over July 2013, a significant change over the 1.2 percent decline in lawyer headcount measured on a year-to-year basis at the end of last year.

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\(^1\) Thomson Reuters gratefully acknowledges the participation of the following persons in the preparation of this Report: James W. Jones, Senior Fellow at the Center for the Study of the Legal Profession at the Georgetown University Law Center (lead author), and Jennifer Roberts, Analyst, Thomson Reuters Peer Monitor.

\(^2\) This report uses the term “mid-size law firm” to refer to firms that are outside the AmLaw 100 and AmLaw Second 100 categories. The mid-size firms included in this analysis averaged 143 lawyers.

\(^3\) As noted in our Mid-Size Law Firm Report issued in March 2014, overall demand for the services of mid-size firms declined in 2013, as contrasted with the performance of larger firms, where growth in demand was essentially flat. That negative demand growth was reflected in a decline in average fees worked by lawyers in mid-size firms in 2013, during the same period that fees worked in larger firms were growing.

\(^4\) The “demand” for services is measured by the total number of billable hours recorded by firms in a particular category.

\(^5\) “Fees worked” refers to the fees actually generated by a firm’s timekeepers over a specified period.

\(^6\) “Worked rates” refer to the average rates actually billed to clients by firms. They may be contrasted with standard rates, which may or may not be reflected in actual billings.

\(^7\) “Productivity” is measured by dividing the number of billable hours recorded by a firm in a given period by the average number of FTE timekeepers during the same period.
Also worth noting was the practice mix reflected in the improved demand figures from the first half of the year. As shown on Chart 2, mid-size firms experienced positive demand growth in corporate and transaction oriented practices (including general corporate, labor/employment, real estate, and tax), while seeing negative demand growth in litigation and bankruptcy. The latter is particularly significant since litigation is the largest practice area among mid-size firms, accounting for 37 percent of the total market. This general pattern of demand growth tracks the performance of larger firms as well, where corporate and transactional practices have moved into positive territory while litigation practices have remained fairly sluggish.

While the increase in demand for the services of mid-size firms seen in the first half of the year is encouraging, the improvement remains -- as noted above -- fairly fragile. The mid-size market still trails both AmLaw 100 and AmLaw Second 100 firms in almost all key performance measures, and in some cases by significant margins. During the first half of the year, for example, demand for the services of AmLaw Second 100 firms (measured on a YTD basis) grew by 2.9 percent (compared to a decline in demand of 0.6 percent for mid-size firms) and average fees worked by AmLaw Second 100 firms increased by 6.0 percent (compared to an increase of 2.2 percent for mid-size firms).8 These patterns can be seen on Chart 3, which tracks demand growth for all three law firm segments over a 9-1/2 year period since Q1 2005.

The lag in the performance of mid-size firms can also be measured in terms of revenue growth. Following the first half of 2013, the mid-size market actually led the other sectors in terms of revenue growth, recording positive growth (measured on a YTD basis) of 1.2 percent compared with only 0.5 percent for AmLaw 100 firms and 0.3 percent for AmLaw Second 100 firms. But a year later, the larger firms had roared back with revenue growth (at July 2014) of 3.7 percent for AmLaw 100 firms and 4.3 percent for AmLaw Second 100 firms, as compared to only 1.5 percent for the mid-size market.10

The challenge for mid-size firms going forward is how to capitalize on the positive momentum reflected in the improved demand numbers for the first half of 2014. As we have noted before, mid-size firms face special challenges that are somewhat different from those of their larger counterparts. These include the issue of size itself (i.e., whether a firm has sufficient “bench strength” to attract the kind of clients and business that it wants), as well as the growing threat that ever improving technology will drive the commoditization of services at the lower end of the legal market much faster than at the top. To these might be added the lingering sluggishness in demand growth for litigation services, an area of practice on which most mid-size firms are heavily reliant.11

What all of this suggests is that it is more important than ever before for leaders of mid-size firms to think strategically, to focus on bolstering key practices, to take a careful look at their firms’ use of technology and how it might be expanded to better serve their clients, to consider all of the ways in which their firms might improve the efficiency of service delivery, and to be increasingly proactive in their client relationships. Indications are that the leaders of many mid-size firms are beginning to focus their efforts in precisely these ways.

Responding to a recent survey by Thomson Reuters and the Association of Legal Administrators, leaders of 47 mid-size firms identified the three most positive factors affecting their firms’ 2013 performance as winning new business based on their firms’ values (45 percent), focusing on becoming more efficient (43 percent), and focusing on growing select practices (38 percent). And significantly, they identified the same three factors as the most important ways for them to drive growth in 2014, but by even wider margins.12

Clearly, the legal market has changed in fundamental ways since the beginning of the current economic downturn in 2008, and there is every indication that many of those changes -- particularly client focus on cost effectiveness and efficiency in the delivery of legal services -- will continue to impact the competitive landscape for a long time to come. Firms that are able to embrace these changes and to respond proactively to them will enjoy a significant competitive advantage over those that cannot.

8 Source: Thomson Reuters Peer Monitor.
9 This analysis includes all timekeepers and all matter types (billable and contingens).
10 These revenue growth figures are also reflected in the cash collection performance of mid-size firms. At mid-year 2013, mid-size firms reported growth in cash collections of 4.4 percent, substantially higher than the other market sectors. By mid-year 2014, however, mid-size firms reported increases of only 0.9 percent, significantly below the performance of larger firms. Source: Thomson Reuters Peer Monitor.
11 Among 47 mid-size firms participating in a survey conducted last month by Thomson Reuters and the Association of Legal Administrators, 72 percent indicated that litigation was one of their firms’ largest practice areas.
12 In terms of driving growth in 2014, the 47 responding firms identified the most important three opportunities as winning new business based on their firms’ values (83 percent), focusing on growing select practices (49 percent), and focusing on becoming more efficient (43 percent).