PEER MONITOR
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Q1 '09 EXECUTIVE REPORT ISSUED 5.10.09

Pricing Pressure, Demand Volatility Straining Law Firm Business Model

Overall demand for legal services declined in the first quarter of 2009, continuing the significant downward trend the Peer Monitor® Economic Index (PMI) recorded in Q4 2008. Firms making up the PMI reported that demand was down 8.2 percent compared with Q1 2008. However, while demand fell precipitously in January and February, there was a flattening in March. Although this is a promising sign, it remains to be seen whether it is merely a blip in the pattern or a bottoming out of the downward economic trend. We expect that demand will continue to be somewhat volatile for at least the next few quarters.

Compounding already difficult operating conditions, the market is now in a more rate-sensitive environment, resulting in lower fee growth. Rates grew at only 2.9 percent in the first quarter, the slowest rate growth experienced over the past few years and significantly below the 7.9 percent growth that occurred during Q1 2008.

We do see some bright spots, including some counter-cyclical practice areas, such as bankruptcy and high-end litigation, which are now very active. Generally speaking, however, the typically recession-driven practice areas are not following the traditional pattern tracked in prior slowdowns, nor are they showing enough strength to fully compensate for the void left by slowing practice areas.

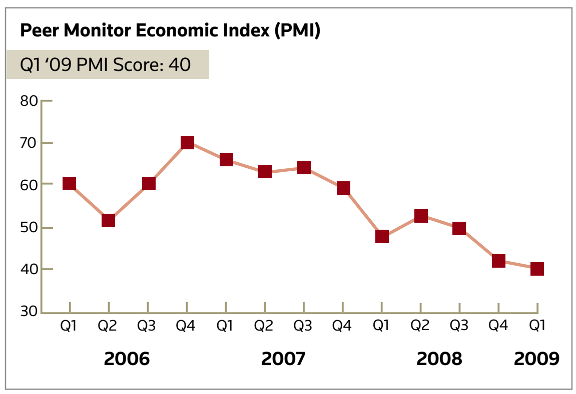
As a result, the PMI fell slightly to a reading of 40 in Q1, essentially flat to the previous quarter. This neutral overall index performance is a result of the soft demand and rate conditions, weighed against the very aggressive measures taken by law firms to cut costs. Underlying these actions are questions about whether significant changes to the traditional law firm business model – such as alternative pricing arrangements, new staffing models, merit-based associate compensation, and new client development and service strategies – are likely to emerge as a result of the current downturn. It is possible that we will ultimately look back on this recession as a turning point in the evolution of law firms toward more efficient and cost-effective models.

Demand Analysis by Market

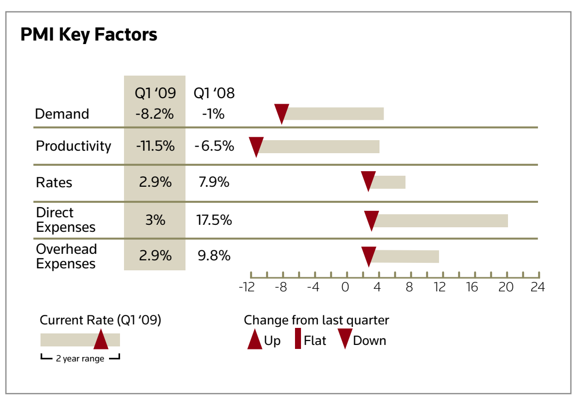
While all markets represented in our database contracted in Q1, San Francisco represented the strongest major legal market, showing only a slight decline of 1.2 percent compared with the same time a year ago. Chicago and Los Angeles showed weak demand, down 8 percent. New York, Washington, D.C., and London were among the weakest, contracting as much as 12 percent. The Midwest represented the strongest region with flat growth.

Demand Analysis by Practice Area

Bankruptcy picked up the pace of activity this quarter, up 13.2 percent from a year earlier. Litigation work was flat, although there were signs of an upward trend by quarter-end with positive growth into March. It appears that the increasingly high cost of litigation may be slowing growth in that practice sector, with the result that the traditional counter-cyclical benefits that litigation has provided in prior downturns have yet to be realized. Labor and employment work was more active in some market segments, but overall remained relatively weak compared with 2008. M&A activity in the U.S. inched into positive growth territory in the first quarter. However, this was likely a result of a few specific mega-mergers in the pharmaceutical sector, and thus may be an aberration for the period.



The PMI represents the relative rate of change among the major factors influencing law firm performance. These factors are tracked individually in the graph below.[2]



1 Demand is defined as the growth in billable hours.

2 March 2009 had up to two more working days than March 2008, depending on considerations for holidays, but January and February 2009 had up to three fewer working days compared with 2008.

3 The PMI is a composite index score, representing the quarter-over-quarter change in drivers of law firm profitability, including rates, demand, productivity and expenses. Positive factors driving firm profitability will produce a higher score. A score exceeding 65 generally indicates a healthy operating environment.

4 It should be noted that the Thomson Reuters Mergers & Acquisitions Review reported a 10.1 percent uptick in the dollar value of U.S.-based M&A activity in Q1 2009 compared with a year ago, largely due to a small number of mega-deals in the pharmaceutical sector.

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Intellectual property work was weaker in Q1 compared with a year ago, shrinking by 9.5 percent. This was affected by a relatively high benchmark of comparison, as patent litigation recorded very strong growth in the first half of 2008, especially when compared with other practices. While intellectual property work overall will continue to evolve as an important growth area for many firms, certain subsegments, such as IP litigation, are likely to continue to feel the effects of pressure from clients around costs and value.

Rates

Rates present a new challenge to operating performance for firms in 2009. Rates grew only 2.9 percent in Q1 compared with 7.9 percent a year earlier, the slowest growth in the four years that PMI has been tracking data. Rates in major markets, including Los Angeles, New York and Washington, D.C., fared slightly better than the industry average, achieving around 4 percent growth, but were still sharply down from a year ago.

In recent years, annual rate growth has averaged about 7 percent. This alone accounted for much of the growth in profitability for firms over that time period. The fourth quarter of 2008 recorded 5.8 percent growth, marking the first decisive break below the long-term trendline. The first quarter of 2009 has now extended the recent downward trend further, compounding pricing challenges on top of declining demand. Sustained pricing sensitivity by clients may very well serve as the stimulus for more widespread adoption of alternative pricing models to better meet clients' needs.

Expenses[5]

Against the backdrop of these soft economic conditions, Peer Monitor firms have taken bold, aggressive steps to trim their cost structures. Firms reduced expenses sharply in Q1 and are quickly moving to bring costs in line with shrinking fee revenue. Direct expenses grew at their slowest rate since PMI began tracking expense data over the last three years – up only 3 percent, compared with 17.5 percent a year earlier. Reductions in headcount and hiring, along with changes in compensation schemes, bolstered firms' abilities to dramatically cut direct expenses. Additionally, the absorption of rising associate salaries in 2008 established high benchmarks for many firms, which helped to provide favorable year-over-year comparisons. Many of the cost savings associated with the headcount reductions announced in Q1 2009 should carry through into the second quarter, generating additional favorable comparisons.

Overhead expenses have been also shrinking for the past year and Q1 continued that trend with the growth rate slowing to 2.9 percent. Marketing and client development expenses, as well as office expenses, declined on an absolute per-lawyer basis.

Productivity

Productivity, as measured by hours per lawyer, continued to decline in the first quarter. While firms continued to slow the rate of lawyer growth, the benefits of attorney headcount reductions over the last two quarters have not yet been fully realized because of lags in departure dates. The second quarter of 2009 should show more of the effects of headcount reductions and productivity improvement, as the second quarter historically provides the strongest productivity gains for the year.

Outlook for 2009

2009 will continue to be one of the most challenging years in recent times. Firms will continue to reduce costs to better match declining demand and revenues, and modify their compensation, staffing, and pricing strategies to meet the changing realities of the marketplace.

Although demand is showing signs of a possible bottoming out, and counter-cyclical practice areas are now showing some strength, the coming quarters will help to validate the actual direction of demand trends. We project demand and pricing to remain generally weak throughout the remainder of 2009.

Client pressure on fees and service arrangements will continue to accelerate, and firms will increasingly move toward alternative fee arrangements that go well beyond traditional discounts.

On the expense side, firms will continue to slow spending until a better balance with revenues is realized. However, rather than merely adjusting headcount, more forward-looking firms will take the opportunity to explore significant changes to staffing and compensation models. This includes reexamining firm timekeeper mix, and moving toward more innovative, flexible structures such as merit-based compensation schemes for associates.

While conditions may remain difficult for some time, change inevitably creates opportunities for firms to take steps to help secure long-term competitive advantage. Consequently, firms now have a chance to reexamine many basic tenets of the law firm business model that would otherwise have been difficult to address during better times. The key will be focusing on areas that align with the strengths and overarching strategy of the firm. One size will not fit all, however. Firms that are opportunistic and strategic in response to rapidly changing market conditions will be better able to ride out the economic storm and position themselves for long-term growth.

About Peer Monitor

Peer Monitor serves large law firms across the Am Law 250. The Peer Monitor benchmarking model allows detailed analysis of 33 U.S. and international markets and over 20 practice areas.

For more information, please contact Mark Medice at 412-203-2155 (email: mark.medice@thomsonreuters.com), or visit peermonitor.thomson.com.

5 Includes both direct expenses and overhead expenses. Direct expenses are salaries, fringe benefits and professional fees associated with billable timekeepers. Overhead expenses include all other nondirect expenses, including staff compensation, marketing, technology, occupancy, office expenses and research.

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