Corporate and Commercial

A perspective on the legal market

2014/2015
year in review
and what lies ahead

November 2015

NatWest

Foreword

Buoyed by a sustained economic revival, booming real estate and transactional markets and a favourable focus on cost management, leading UK law firms enjoy a confident position on both the domestic and international stage. Foreign concerns continue to enter the UK market, primarily in London, while consolidation continues apace throughout the UK as firms seek to benefit from economies of scale.

Against this backdrop, the business of law remains a significant and highly profitable contributor to the overall economy. Despite pressure being exerted globally due to fixed (or static) fees, adverse currency fluctuations and market turmoil in the eurozone, Middle East and Asia, UK firms remain visible on the key mandates driving global economic activity.

All of this comes as firms grapple with fundamental questions regarding the traditional business-law model. The profession's ability to address changing expectations from stakeholders – clients, staff, partners, investors and regulators – regarding service, culture, profitability, value, delivery, risk and reward will define those firms that occupy the upper echelons of their chosen markets going forward.

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Supporting growth and development

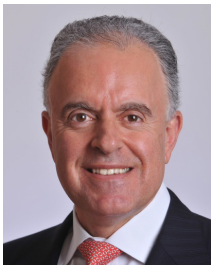
I am pleased to share with you my latest report on the legal sector, which includes unique insights into, and perspectives on, the profession. This is based on extensive research and analysis, and draws on the vast breadth of knowledge and experience we have gained in banking and the legal sector over many years through our dedicated team of professionals focused exclusively on the legal profession.

The UK legal sector continues to be extremely important to us. We have a strong market share in the legal sector, and a long and proud history as bankers to the leading law firms in the UK market. We continue to grow our business both domestically and outside the UK through our demonstrable and proven commitment to the sector. We actively supporting the growth and development of the UK market and the rapid globalisation of the legal sector.

Our commitment to our clients and our leadership in the sector is unwavering, and I commit to continue delivering the legal profession leading banking advice, products and services in addition to cutting-edge research and commentary on the profession. It gives me great pleasure to provide you with the analysis and findings within this report. I hope you find it useful.

James Tsolakis

Contents



About the author

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Executive summary

The legal profession has undergone a period of significant restructuring over the past seven years, and the process is far from complete. Despite extremely benign economic conditions, vibrant transactional markets, a hot litigation scene and booming sectors such as real estate and technology, profit remains restricted as more and more lawyers compete for the shrinking amount of work available.

In the years preceding the global financial crisis, UK law firms were at the peak of their powers, charging their lawyers out at historically high rates, at all levels of the organisation. Firms had begun to pay lip service to the fact that back-office functions and certain administrative tasks could be outsourced to less expensive providers. But, they still made a high percentage of profit from using highly qualified professionals to undertake relatively low-level commoditised work. Those days are officially over. Legal work has now been unbundled as a result of a client revolution on pricing, value and service delivery.

Routine work must now be charged out at routine rates, either directly by the firm at a lower-cost centre or by an external specialist provider. Online legal-service companies, document-review providers, contract lawyers and due-diligence specialists have also entered the market, further diminishing the profit pool of established law firms.

"Legal work has been unbundled as a result of a revolution on pricing, value and service"

Non-legal competition

Non-legal entrants such as accountancy firms – the big four are all now armed with Alternative Business Structure (ABS) licences – are quietly winning a lot of commoditised and tax-based work that was previously going to traditional law firms. To put this into context, the legal arm of PwC posted UK revenues of £41 million alone last year.

With many legal instructions becoming increasingly process-driven, the accountants have an obvious appeal to the modern, cost-savvy client, who now views efficiency, standardisation and a move away from expensive hourly rates as the norm in many areas of legal work.

Accountancy firms already have the cheaper cost centres and cutting-edge technology. They are also well established in under-lawyered emerging markets that large international firms have not yet conquered. Add other entities with ABS status, such as the newly listed law firm Gateley plc and the legal arms of household-name companies such as BT and Direct Line, into the mix and the threat of well-capitalised entities competing for the best talent, work, technology and know-how becomes more acute.

The upshot of all of this upheaval is that legal work has become disaggregated, with significantly bolstered in-house teams acting as de facto project managers to a host of legal and resource providers. The traditional law firm is just one constituent part – albeit, in many cases, the one doing the most complex, more profitable work. →

That this should happen to a sector that had delivered very successfully for its lawyers and clients for centuries is not surprising when you look at the transformation going on in the arenas in which law firms are active. Highly disruptive companies using technology and innovative thinking to transform entire sectors in a bid to make them cheaper and more accessible for the consumer has become one of the biggest business trends of the past five years. Law is clearly no different.

Be optimistic

So what to do? As this report makes clear, there is much for UK law firms to be optimistic about despite the threats to their market share. The mid-market has had a stellar year, with profit gains that easily outpace their more illustrious magic-circle and top City rivals. Mid-tier firms have worked hard on addressing their heavy cost bases, falling fee levels, and often-dated technology and real estate infrastructure. There is also little doubt that the large number of law-firm mergers in this area of the market has helped significantly. Better economies of scale, increased profitability to attract lateral partners and expand geographically, reconfiguration of the equity population, improved pricing and financial management are all benefits that can come from a winning law-firm combination.

Booming property, disputes and deal markets have also helped achieve more profitable revenue growth. And those that are ahead of the curve when it comes to the outsourcing of commoditised legal work are finding it easier to get more profitable rates for their more sophisticated advice. The trick now is for this grouping to continue to grow revenue and profitability after delivery of one-time gains available from execution of previous initiatives, and during the next year.

The resurgent performance of the mid-tier firms contrasts with their more globalised rivals at the top of the market. They have seen revenues remain largely static on the back of exposure to currency fluctuations, geopolitical unrest and a powerful global threat from the top US players. While the top UK players still post huge profit and income figures, it remains difficult to see where growth will come from globally in the next year, not least with economic clouds gathering over many of the world's legal hotspots, including the UK.

A two-pronged strategy

In many ways, law firms at all levels must consider a two-pronged strategy when dealing with the threats outlined here. First, it is clear that having heavy, fixed-cost bases irrespective of activity levels or economic conditions cannot be sustained in this new era of providing cost-effective legal services to clients. Firms must become more proactive in managing their staffing, real estate and other key costs to fit rising and falling markets. This is the approach long undertaken by investment banks and many corporates. While law firms are generally better hedged and thus inherently more conservative in their approach to dealing with issues such as large-scale lay-offs, for example, those nimble enough to roll with the markets will have a clear advantage over more traditional rivals. Secondly, firms must have a clear point of differentiation and be focused on those areas of the market that can deliver the better-quality instructions at the most profitable levels.

These elements are clearly not mutually exclusive and the savvier firms have indeed been focused on both of these since the global financial crisis seven years ago redefined markets for all stakeholders, including lawyers. For all firms, adaptability and facing up to the immense changes occurring within the legal profession are no longer simply choices. They are prerequisites for success.

"Law firms at all levels must consider a two-pronged strategy"

Section 1

The economic forecast

While the UK has been one of the strongest-performing economies globally in 2015, all signs point to some choppy waters ahead, owing to a number of key micro and macro economic indicators.

PHOTO: ALAMY

Next year's referendum on the UK's EU membership is already weighing on markets and there are signs the booming London property market is firmly in bubble territory. Declining commodity prices, geopolitical unrest in Europe, the Middle East and Asia and an economic rebalancing in China are all impacting negatively on domestic and international markets. While financial markets are awash with liquidity to drive transactional activity, the strong prospect of a rise in interest rates is also injecting a degree of caution into corporate spending. All of this will create new challenges for business-law firms, despite the majority being in a much stronger condition in terms of their balance sheet compared to the years immediately following the financial crisis in 2008.

- The closely watched **Markit/CIPS UK Purchasing Managers' Index** showed services activity fell to a 27-month low of 55.6 from 57.4 in July. The index signals a growth for readings above 50, compared with the previous month, and contraction for readings below 50.

- In September, the **EEF manufacturers' organisation** slashed its 2015 growth forecast to 0.7%, down from 1.7% at the beginning of the year. It said a stronger sterling, combined with an emerging market slowdown, China turmoil and sluggish eurozone growth have all hit the manufacturing sector hard.

- The **European Central Bank** kept its main interest rate on hold at 0.05 per cent in September, but cut its growth and inflation forecasts for 2015 and the following years. It is now forecasting eurozone economic growth of 1.4% in 2015 (down from 1.5%) and 1.7% in 2016 (down from 1.9%). The ECB expects inflation to be 0.1% in 2015, moving to 1.5% in 2016 and 1.7% in 2017.

Looking ahead to the end of 2016, the **Organisation for Economic Co-operation and Development** forecast in June 2015 that:

- Economic growth will gradually strengthen to 2.25% by the end of 2016, supported by lower oil prices, the depreciation of the euro, improving financial conditions, additional stimulus from further monetary expansion and a pause in fiscal adjustment. However, unemployment will decline only gradually, to a rate of 10.25% at the end of 2016. Inflation should edge up to around 1.5% as the effects of lower energy prices dissipate and monetary easing is stepped up. Risks are broadly balanced around the projections, although event risks surrounding renewed financial turmoil remain significant. ■

In October 2015, according to the International Monetary Fund:

- Global growth declined in the first half of 2015, reflecting a further slowdown in emerging markets and a weaker recovery in advanced economies.
- It is now projected at 3.1% for 2015 as a whole, slightly lower than in 2014, and 0.2% below the forecasts in the July 2015 World Economic Outlook Update.
- Prospects across the main countries and regions remain uneven. Relative to last year, growth in advanced economies is expected to pick up slightly, while it is projected to decline in emerging market and developing economies.
- With declining commodity prices, depreciating emerging market currencies, and increasing financial-market volatility, downside risks to the outlook have risen, particularly for emerging market and developing economies.
- Global activity is projected to gather some pace in 2016. In advanced economies, the modest recovery that started in 2014 is projected to strengthen further.
- In emerging market and developing economies, the outlook is projected to improve: in particular, growth in countries in economic distress in 2015 (including Brazil, Russia, and some countries in Latin America and in the Middle East), while remaining weak or negative, is projected to be higher next year, more than offsetting the expected gradual slowdown in China.

Section 2

Global expansion

Risks and rewards

While the rush to achieve global scale has defined the most successful UK law firms over the past two decades, the 'big is beautiful' mantra has undoubtedly taken a significant (and surprising) battering this year. For most forecasters, 2015 was supposed to be the year the big boys hit record profit and revenue numbers, after spending the post-crash years re-engineering their firms into lean, mean profit machines.


Shanghai Skyline

PHOTO: ALAMY

We have seen soaring real estate and transactional markets globally, big-ticket flotations, lucrative disputes work and more efficient ways of delivering legal advice. This meant the market was braced for some breathtaking results from the magic circle and premium UK global players. So, what went wrong? There were big falls in the euro/sterling exchange rate in Q3 and Q4, combined with global pricing pressures. Added to this was an economic shakedown in China, significant unrest in the eurozone and Middle East, and intense competition for headline corporate and regulatory mandates from their booming US rivals (see p22). All this delivered some less than spectacular numbers by historical standards. According to data compiled by *Legal Business* magazine, the combined revenues of the big-four global UK players – Clifford Chance, Linklaters, Allen & Overy and Freshfields Bruckhaus Deringer – rose by 1% to £51.14 billion, with profits per equity partner staying flat at £1.27 million.

While the UK and US markets are recovering strongly from recession, there are few, if any, parts of the top UK firms' global empires that aren't currently undergoing a degree of economic market uncertainty. Issues relating to over-lawyering, pricing pressures, quality control and tensions with local regulators add to management concerns. Here, we take a look at the prospects of some of the key global jurisdictions in which the top players are currently invested.

Australia

With Hong Kong and Singapore remaining considerably over-lawyered, and with a confidence-inspiring mining boom to get lawyers salivating, Australia seemed for a while to be the answer to both recession at home and a slowdown in global growth. Top UK firms, including Clifford Chance, Allen & Overy, Herbert Smith Freehills, Norton Rose, Ashurst and Linklaters, piled into the market, which had remained relatively unscathed from the banking crisis, buoyed as it was by a mining bonanza fuelled by strong Chinese demand.

The UK and Australia share similar legal systems and are culturally compatible, so expansion here seemed an obvious route for many firms. Unfortunately, some big question marks hanging over the countries' potential to achieve major profit growth for the new UK incumbents. These include large falls in commodity prices, slower Chinese demand, a weakening Australian dollar and an increasingly over-lawyered market. Anecdotal evidence suggests pricing pressure is acute and that procurement experts are increasingly driving cost negotiations on behalf of clients.

While the economy is holding up relatively well, firms are looking to other sectors such as technology and communications and financial-services regulatory work to drive growth. There are also some large infrastructure projects, particularly in the transport sector, to keep law firms busy. Nonetheless, companies are bracing themselves for an uncertain year as they look to fill a void left by the still-tanking commodities sector.

China

Big drops in the Chinese stock market, combined with the economic correction currently taking hold, means China has become an even tougher place to operate for UK firms. Partners indicate that domestic Chinese firms are sucking up most of the inbound work at low, often fixed, fees and the global firms are competing for the sophisticated transactional outbound work, litigation (which is →

REVENUES for the big four global UK players rose by

1%

"Plans to revitalise economic growth through stimulus and increased public spending makes South Korea one to watch"

flourishing) and debt-finance advice.

The sheer size of China's economy means the majority of firms are not considering leaving. Nonetheless, according to data released by China's Ministry of Justice, there were 178 foreign firms in China with 225 representative offices in 2014/15. This is down from 178 and 233 respectively the previous year. While some of this drop can be explained by mergers and some law firms collapsing, the figures illustrate starkly how this is a market for those prepared for the long haul.

South Korea

Following South Korea's signing of free-trade agreements with the US and EU in 2012 and 2011 respectively, more than 20 US and UK law firms have launched here. They are forbidden from hiring local lawyers until at least 2016, so work is focusing on the fast-growing arbitration market and cross-border transactional work. While economic growth in South Korea has been sluggish at best over the past five years, plans to revitalise growth through stimulus and increased public spending makes South Korea, Asia's fourth-largest economy, one to watch.

Africa

On the back of better political stability, improved domestic demand, enhanced macro-economic management and a fast-growing middle class, economies across Africa have experienced unprecedented growth over the past five years.

The numbers here speak for themselves: a growing population expected to double to 2.4 billion by 2050, giving it a massive 25% share of the entire global population. Private equity and sovereign wealth funds are already allocating large amounts of capital for infrastructure, retail, energy, real estate, technology and mining projects.

While Africa is a notoriously difficult place to do business, with marked cultural and regulatory differences between each of its 54 countries, law firms are nonetheless gearing up their Africa capability through specialist teams, alliances and dedicated Africa desks within their networks. Firms have yet to make wholesale moves into the continent, however, due to serious concerns over security, corruption and political upheaval.

While anecdotal evidence suggest some tensions between the UK firms' way of operating and that of local firms on the ground, stronger relationships are being built. However, with Chinese investment into Africa infrastructure and mining driving a significant part of the continent's growth story, the slowdown in China and the collapse in commodities prices is putting a break on Africa's booming markets. Law firms should be watching developments closely.

Middle East

Following its $10 billion bail-out by neighbouring Abu Dhabi six years ago, Dubai has recaptured much of its lustre, with deal markets booming at a level not seen since before the crash. Like other big expat locations, such as Hong Kong and Singapore, the market is over-lawyered, yet the sheer number of investment banks, local and international private-equity houses, sovereign-wealth funds on the ground means it continues to provide rich pickings for UK firms.

Oil-price concerns have introduced a degree of doubt in terms of the liquidity of some investors and a willingness to invest in new projects. But Dubai, along with its more locally focused ally, Abu Dhabi, should continue to shine.

Latin America

Of the few potentially lucrative global markets that remain under-exploited by UK lawyers, Latin America remains at the top of the list. It is under-lawyered, yet churns out a high amount of transactional work, both inbound and outbound, continuing despite rapidly contracting economies in some countries such as Brazil and Venezuela. Litigation, and regulatory work are booming, according to those on the ground, with natural resources and energy deals also active following denationalisation in some countries.

Around $131 billion of new mining investment is also expected to flow into Chile and Peru – both copper rich – in the next five years. The market nonetheless remains challenging politically and suffers from widespread uncertainty with regard to regional economic activity. Like many other regions across the globe, the collapse in commodities prices, the devaluation of the Chinese yuan and the prospect of an imminent US hike in interest rates are putting significant downward pressure on growth.

25%

Africa's predicted share of the entire **GLOBAL POPULATION** by 2050

Section 3

The mid-tier bounceback

How long will it last?

In the years preceding the economic crisis in 2008, the UK mid-tier was not a place anyone really wanted to be. Squeezed by the international, better-hedged law-firm brands above them and the intensely focused, better financially managed boutiques below them, many found their revenues freefalling. Mid-tier firms suffered from having little differentiation from their rivals, bloated cost bases, declining fee levels, poor technology, and battered corporate and real estate markets. →

Fast-forward seven years and the resurgence of many firms in this grouping has been little short of spectacular. There can be no doubt that the high number of mergers and significant lateral hiring in this area of the market has helped focus some of the incumbents strategically, and this is now translating into the numbers. Economies of scale, pricing, vastly improved financial management, and increased profitability to attract lateral partners and expand geographically are all benefits that can emerge from the right law-firm combination. Booming real estate, litigation and deal markets have also helped drive more profitable revenue growth. Meanwhile those that have embraced the outsourcing of commoditised legal work are finding it easier to get the rates they want for more sophisticated advice.

What the future holds

According to research by Deloitte, the top 100 UK firms grew their income by 6.8% in the first quarter of 2015, compared with the same period in 2014. However, the mid-tier (those ranked 51 to 100 according to the study criteria) saw revenues rise by 13.6%, easily outpacing the four global members of the magic circle. Indeed, this latter grouping, being more exposed to currency fluctuations and geopolitical pressures, have seen revenues remain largely flat for the financial year 2014/15, according to the main legal benchmark surveys.

But, the key questions for management teams at mid-tier firms are clear. How much were this year's impressive financial results due to an improved economic environment and how much were they due to having the right strategy? In many ways, the current financial year will be the better test of how many are faring. Indeed, our NatWest survey of the UK's leading law firms, which was carried out in September 2015, found that 62.9% of firms expected the number of hours billed during 2015/16 to stay the same as in 2014/15.

The survey also found that an overwhelming 85.19% also expected billing rates to remain static over the same period. With other costs such as salaries, technology and rents increasing, these findings do not bode well for many UK law firms. The majority (55.56%) of our survey respondents believe that profits will remain static over the current financial year, with 3.7% thinking they will decrease. On a macro level, the UK real estate market is heading towards bubble territory in London, and deal markets are cooling ahead of an expected interest rate rise. Inbound activity is being affected by political and economic activity in the eurozone, while the thorny issue of the in/out referendum on our EU membership continues to exert downward pressure on markets.

6.8% The amount **INCOME GREW** in the top 100 UK firms in the first quarter of 2015 (source: Deloitte)

13.6% REVENUES ROSE for mid-tier firms (those ranked 51 to 100 in the study)

PHOTOS: ALAMY

"Differentiation and a clear brand identity have never been more important"

The need for differentiation

Mid-tier firms are also suffering intense competition from the big-four accountants, which are quietly taking the more commoditised work away from them (see p16), while clients remain committed to fee reductions and fixed-pricing arrangements across the board.

Differentiation and a clear brand identity have never been more important, as clients become much more selective about whom they instruct. The days of the single provider are, by and large, over – and this includes clients giving work to non-law-firm entities. With Gateley plc proving it is possible to get a £30 million investment war chest together by floating on the London Stock Exchange, under the provisions of the Legal Services Act, many firms could simply be outgunned by better-capitalised rivals in the search for talent and new revenue streams. With such existential threats coming at the traditional law-firm model from almost every angle, an ability to adapt quickly must be displayed by any firm looking to grow and prosper.

Innovative thinking

Efforts by some firms to launch consulting arms are a good example of the more innovative thinking required in today's market. Not only does it represent a brand-new income stream, it also delivers a clear message to clients that their lawyers can help them with business issues as well as legal ones. The trend towards collaboration with external document review, forensic evidence, contract lawyer providers and a host of other outsourcing organisations is also helping generate better margins by getting routine work done at an appropriate price point.

That law firms are expected to put the brakes on their own recruitment over the forthcoming year was underlined by our survey results. These found that 72% expected the number of lateral partner hires to remain at 2014/15 levels, 68% predicted the number of lateral associate hires to remain the same and 88% thought trainee intake would remain static year on year. Thus, growth over and above that posted in 2014/15 would need to come from firms working more profitably both within and outside the traditional law-firm environment.

Make no mistake, short of yet another wave of opportunistic or distressed merger deals, mid-tier law firms are unlikely to emerge unscathed from these seismic market changes unless they truly commit to a modern, more innovative law-firm model.

Many mid-tier firms have seen a spectacular uplift in profits this year

Section 4

Debt, equity and the new ABS reality

Law firms, with their conservative culture, stable cash flows, and counter-cyclical practices generally deliver reliable credit performance. Indeed, their long-term borrowing has increased by 28% over four years. This is up from £5.75 billion in 2010 to £7.3 billion in 2014, according to research published this year following an analysis of law-firm accounts at Companies House.

Shorter-term lending such as overdrafts has reduced from £2.4 billion to £1.8 billion over the same period. While law's reputation as a safe asset class was tarnished by the well-publicised collapses of Halliwells and Dewey & LeBoeuf, firms remain well placed to take advantage of the strong levels of liquidity available in the market.

"Poor cash management is the single biggest drag on financial performance"

The perfect storm

Firms are also better capitalised as a result of cash injections from salaried partners whose tax status has recently changed as a result of sweeping new HMRC requirements. Against this backdrop, and in stark contrast to the gloomy days of the recession, law firms are undoubtedly benefiting from the perfect storm of high profits per partner, buoyant real estate and deal markets, healthy levels of market liquidity and low interest rates, and new capital payments into the business. Yet with escalating property rents, IT investment, expansion costs and sustained pressure on fees, this does not mean they are able to take their eye off the ball.

As demonstrated by our global economic analysis (see p10), markets are braced for a rocky ride in 2016. There are predicted interest-rate rises, eurozone unrest, key sectors such as real estate and tech entering bubble territory, China beginning an economic correction, falling commodity prices, and the possibility of 'Brexit' all conspiring to dent confidence.

Moreover, the economic recovery of the past year means firms are taking on more lawyers, contemplating mergers and recruiting large numbers of lateral partners. They are also dealing with high-profile partner losses and a London associate salary war.

Analysing lock-up

According to leading benchmarking surveys, law firms are still not turning billed work into cash quickly enough, with lock-up of three months considered the norm in many cases. However, the NatWest survey of the UK's leading law firms, carried out in September 2015, found they are now paying more serious attention to this area.

Almost two thirds (64%) expect average debtor days to shorten over the next year, with just 16% expecting them to lengthen. More than half of those surveyed (52%) also expect the average number of days outstanding in WIP to shorten, with a minority of 12% expecting them to increase. Moreover, the vast majority (84%) do not plan to pay out profit any faster to partners, indicating they wish to keep capital in the business for as long as feasible. These are encouraging numbers, and it is hoped the year-end figures will back up these predictions.

Poor cash management

Poor cash management is perhaps the single biggest drag on financial performance, not least because the longer an invoice remains unpaid, the less chance the firm is likely to see all of the cash. For those looking for debt facilities, proven working capital management disciplines are a key component of any assessment by a lender. A quarter of our survey respondents (24%) said they expected their planned committed credit lines for 2015/16 to increase, with the remainder expecting them to stay the same. With no firms saying they plan to decrease their credit facilities, it is clear that having sound financial management is of key importance in the current market. ➔

52% *expect* average number of days outstanding in WIP to **SHORTEN**

12% *expect* average number of days outstanding in WIP to **LENGTHEN**

Having sound financial managent is key in the current market

PHOTOS: ALAMY / THINKSTOCK

Of course, the 2015 IPO of Gateley plc, which became the first British firm to float when it went public in June, is being closely watched by firms seeking alternative sources of capital. The move, made under provisions in the Legal Services Act 2007, which opened the legal market up to external investment in 2011, gives firms a significant new means of funding expansion. Gateley plc raised £30 million through the listing, with the business valued at £100 million at flotation, making paper multi-millionaires of some of the partners.

LIBERALISATION OF THE LEGAL MARKET

Indeed, liberalisation of the legal market has taken a massive step forward across the board, with the leading accountants, including KPMG, PwC and EY, all now having Alternative Business Structure (ABS) licences. PwC, posted legal services revenues of £41 million in the UK this year, and has outlined ambitious growth plans for its legal division. This undoubtedly raises the stakes for established firms as they seek to protect existing market share and invest in the cutting-edge technology required to compete.

With much legal work becoming increasingly process-driven, these accountants have an instant appeal to today's cost-conscious clients, who value efficiency, standardisation (where appropriate) and a move away from expensive hourly rates.

Accountancy firms have excellent technology and cheaper cost centres, and they are well established in under-lawyered emerging markets, where many large international firms do not currently have a presence. They are, of course, restricted by regulation in some markets, not least America (the world's biggest legal market) where they are unable to practise law. The collapse of Andersen more than a decade ago has also left lingering issues over conflicts between accountants' legal and consultancy arms.

For now, their strategy is to eschew full-service capability and the trophy hires of rainmaking partners from established firms. Instead, they are focusing on legal areas that complement their own practices, such as compliance, due diligence, employment, immigration and tax. The smart money, nonetheless, is on the accountants going head-to-head with the established legal order over lucrative capital markets and transactional activity once they have taken sufficient market share from the mid-tier.

While established law firms continue to have good access to multiple sources of capital in the current market, the significant economic upheaval and business threats on the horizon point to some tough strategic decisions ahead. Those firms with rigorous working capital disciplines and cash-management systems and clear investment priorities will be best placed to invest into the upturn from a position of strength.

"Economic upheaval and business threats on the horizon point to some tough strategic decisions ahead"

Much legal work has become process-driven

Section 5

The real estate revolution

With real estate spend the biggest expense to law firms after salaries, keeping pace with rapidly increasing office rents is one of the biggest challenges facing UK firms. This is made more acute as domestic and global markets pick up significantly from the lows of the financial crisis. Increased business activity means firms must expand headcount at a time when property costs are at an all-time high. The situation is exacerbated by new market entrants, particularly in London, driving up rents in prime 'trophy' office locations.

Law firms **MAKE LESS EFFICIENT USE OF SPACE** when compared to management consultancies and accountancy firms

2015

1.25 DESKS
(accountancy/ management consultancy)

VS

1 DESK
(law firms)

This financial imperative means that law firms are being forced to radically rethink how their real estate portfolios work for them. A drive towards greater operational efficiency through near-shoring, off-shoring, better technology and more flexible working has been a key component of law-firm change in recent years. In a NatWest survey sent to leading UK law firms in September 2015, an overwhelming 96% of respondents said they saw IT systems as a source of competitive advantage in the legal profession with almost a tenth (8.8%) of back-office functions now outsourced, according to respondents. Interestingly, respondents attributed 7.55% of their costs to technology spend, which amounts to tens of millions of pounds for some of the higher-earning firms.

Rethinking real estate strategies

The movement of more routine work to lower-cost offices domestically – such as to Manchester, Glasgow, Belfast, Bristol and Dublin – and internationally (mainly to Asia) is widely agreed to be a game-changer. Not only does it allow firms room for manoeuvre when dealing with fierce client pressure on fees, but it also allows new lower-cost products for clients to be generated at a fraction of the cost they could be delivered for in major financial centres. Many managing partners spoken to during the research for this report said client satisfaction in this area is key to gaining a greater share of the more sophisticated, higher-value work that is commonly run out of their head office.

But, the law-firm real estate revolution does not stop there. The more forward-thinking firms are now redesigning their offices to support more collaborative working cultures and improved efficiency. One leading firm, canvassed for this report, recently moved into prime London space, previously designed for an investment bank, and grouped its entire staff according to their sector focus. While they report that this has led to greater innovation and collaboration in the way clients are serviced, it has also allowed them to make multi-million pound operational savings. The office had 30% less space than their previous HQ, yet it has allowed them to increase fee-earner capacity by 20%.

This kind of radical thinking, combined with implementation of the latest mobile technology, shows law firms can do much more than move routine legal work to the regions and low-cost centres abroad if they are serious about generating meaningful, long-term efficiencies in relation to their real estate spend.

The need for space efficiency

Indeed, a recent report by real estate company CBRE found law firms were significantly behind management consultancy and accountancy firms in developing efficient space-management strategies. The research showed the latter group could fit more staff (an average of 1.25 per desk compared to one person per desk in the legal profession) in a smaller office space. Worryingly, for law firms, the report predicted the gap would widen further in the next four years, with the accountants and management consultants averaging 1.79 staff members per desk and law firms remaining static at a ratio of 1:1.

The extent to which law firms can change this depends largely on their willingness to move away from cellular office space to open-plan. The CBRE report found the latter occupied an average of 310sq ft per fee-earner compared with 550sq ft with cellular offices.

Location, location, location

In a sector known for its long working days, location remains a key component in attracting top talent, and keeping employees engaged and dedicated – hence the UK's biggest, most profitable law firms are all headquartered in the City, Canary Wharf or Midtown, for example. Nonetheless, a trend towards near-shoring within London is now emerging, with firms looking at smaller, satellite locations in the funds-focused West End, for example, or in parts of East London such as Old Street, a major tech hub. This trend is likely to become more popular over the next year as it takes some pressure off prime-rental costs while also allowing firms to be closer to clients in specific sectors.

With 92% of firms contacted by the CBRE saying the quality of law-firm workplaces impacted significantly on employee performance (and 82% saying they enhanced productivity), it is clear that law firms all over the UK need to strike the right balance from all the real estate options now at their disposal.

PHOTO: ALAMY

Law firms' biggest expense after salaries is their real estate

Section 6

The transatlantic divide

Battles between UK firms and their US rivals for global supremacy have been ongoing for at least two decades, with their respective approaches to internationalism never looking as distinct as they do now.

Top UK firms, constrained by the size of their home market have, on the whole, followed their clients around the world, building huge brands globally on the back of largely institutionalised relationships. Their US counterparts, meanwhile, buoyed by having the world's biggest legal market in their own backyard, have focused more acutely on profitability, and on tempered international growth.

UK firms have, on the whole, remained wedded to lockstep remuneration for their partners and associates. In the US leaders tend to pay on merit, with key client relationships inextricably linked with the star partners, who earn significantly more as a result. Differences remain between firms, of course, but these two models have undoubtedly come to define opposing transatlantic approaches in 2015.

While opinions as to which model will win out have ebbed and flowed over the years on the back of geopolitical, economic, currency and talent factors, financial results for the 2014/15 year strongly suggest US firms are putting a significant gap between themselves and the top UK firms.

Opposing approaches

At a base level, US lawyers simply generate more revenue than UK lawyers, with the former category touching $1.3 million, according to industry benchmark surveys, compared to around $950k at UK firms. US firms are also more efficient, eschewing bloated bureaucracy, and are significantly better at costs management. This creates higher profit margins, in excess of 50% among some of the US elite, leaving them more room to attract and recruit the best talent, with pay deals that often dwarf the top equity pay of their UK rivals. To put this into context, the top 100 UK law firms saw combined revenue dip 1% to just under £21 billion in the 2014/15 financial year. US firms motored ahead by 5%, posting a combined turnover of $92.87 billion, according to data published by *Legal Business* magazine. US firms also now account for more than £2 billion of revenue in the UK market.

Against the backdrop of a UK market, awash with cheap money, a booming property market, buoyant M&A activity and a still-hot litigation scene, these results are disappointing to say the least. UK management teams counter that they are more exposed to currency-exchange fluctuations (particularly the weak euro) than their less global US rivals. And huge uncertainty in the eurozone and Asia have taken the edge off what would have been a good set of results. While there is of course some truth in this, the increasing financial divide between the two sets of firms points to more wholesale strategic concerns in the UK camp.

PHOTOS: ALAMY

"US firms are more efficient and are significantly better at costs management"

Investment and pricing

Since the 2008 financial crisis turned global markets upside down, UK firms can no longer rely on institutional ties with investment banks to drive the lion's share of profits. New sources of money are filling the void left by the more risk-averse approach that global regulators have forced on the world's top banks. US acquirers and investors, backed by trillion-dollar cash piles and low-interest debt, are dominating top-end transactional work, while US regulators are dominating much of the compliance work, due to their international reach.

The US market, meanwhile, continues to motor on, with the technology, entertainment, and oil and gas sectors, in particular, churning out →

lucrative transactional mandates over the past year. On top of this, anecdotal evidence suggests European General Counsel and procurement managers are far more committed to the 'value' pricing revolution that emerged from the 2008 crash than their US counterparts. All of this plays into the hands of leading US law firms.

Globalisation

US law, meanwhile, is an increasingly popular commodity globally. New banking products, large capital flows into high-yield debt and US bonds mean top UK firms need US capability across the board internationally – not just in global finance centres such as London and Hong Kong – to compete. Moreover, US firms have become more nuanced in their globalisation strategies, preferring in many cases to launch in new markets on the back of specific practice areas such as litigation or private equity. Gone are the days of US firms thinking, for example, that they could dominate London on the back of trophy office space, and the recruitment of a full-service capability from UK rivals. The savvier firms realised long ago that client relationships do not move with London partners in the same way they do in New York. New US entrants to the market these days are focused on the areas where they can genuinely take on the incumbent firms and win market share. This is now happening at a pace that the UK firms in New York simply cannot match.

So, what to do? With seismic political shifts occurring in the eurozone and Middle East, China experiencing significant economic uncertainty, Brazil's debt being downgraded, the Australian mining boom officially over, and the issue of Brexit hanging over the UK market, there do not appear to be many global hotspots where the UK firms can focus their fire (see p10). Improving revenue-per-lawyer figures, better cost control and smarter use of technology will continue to boost UK firms in the long run, but there is a considerable way to go.

For now, the game is all about having the right management team with a clear strategic vision and pitch to clients across all the sectors in which they operate. It is about implementing more flexible remuneration structures so the best talent is not prised away by better-paying US firms. It is about committing primarily, as the US firms have done, to those financial centres where pricing holds up and is not significantly diluted. And it is about properly adapting to the unprecedented economic and political changes that will continue to impact global markets.

"It is about adapting to the unprecedented economic and political changes that impact global markets"

US **INCREASED** 5% to $92.87 billion (source: *Legal Business* magazine)

COMBINED REVENUE FOR TOP 100 FIRMS 2014/15

UK **DIPPED** 1% to £21 billion

Battles between UK firms and their US rivals for global supremacy have been ongoing for at least two decades

Section 7

Risk management

Cyber attacks

When cyber-security firm Mandiant said three years ago that at least 80 of the top 100 US law firms had been the victim of a cyber attack, many commentators hoped it would signal the start of a new era in law-firm IT protection globally. Cyber breaches are concerted attempts to disrupt businesses by reviewing, accessing or removing sensitive information. Law firms hold information at every stage of any legally enforceable business transaction, so are prime targets for hackers. →

In our survey of the UK's leading law firms, carried out in September 2015, a fifth of respondents admitted to being a victim of a cyber-security incident in the past year. Moreover, 64% said they were planning a major technology upgrade. These figures demonstrate that the issue is creeping up the UK law-firm agenda. However, more work clearly needs to be done in order to prevent a major firm hitting the headlines for all the wrong reasons.

GETTING INSURED

Insurers report that law-firm take-up of cyber insurance cover remains worryingly low. Many law firms assuming their cyber liability risk is already covered by the terms of their professional indemnity insurance (PII).

While PII does afford some general cover for cyber breaches, there are a number of exclusions, at various levels of cover, that would render many of the financial costs associated with an attack unrecoverable. Potential exclusions could include breaches that occur while data is in the possession of third parties and the often huge costs of replacing hardware and systems that are compromised through an attack.

The extent of the problem was made clear by a 2015 report published by the UK government, in conjunction with insurance broker Marsh, which said that just 2% of large businesses in the UK have 'explicit cyber cover'. Moreover, the report claimed that only half the businesses with which it liaised were aware that cyber attack could be insured against. This is a worrying statistic.

A benchmarking report published by investigations, intelligence and risk-management firm Stroz Friedberg in conjunction with *Legal Week* concluded that law firms needed to do significantly more to properly manage their cyber risk. It found:

- 86% of lawyers view cyber security as an issue for their management teams
- 75% of employees in law firms with revenues of at least £500 million believe they are likely to be hit by a cyber attack
- Just one tenth of law-firm staff think UK businesses are able to deal with cyber risks

Nonetheless, anecdotal evidence suggests the issue of cyber security is privately becoming a key concern for management, not least because top clients are insisting upon it. Leading investment banks, concerned about the security of their own highly sensitive information, are now asking their law firms to complete lengthy questionnaires detailing their IT security and detection systems. Some are reportedly dispatching their own staff into law firms to carry out security audits.

Lloyds of London released data earlier this year that painted a more optimistic picture of the market for cyber cover generally. The data showed a 50% increase in the demand for cyber-insurance products in the first quarter of 2015 compared to the same period last year.

"Many firms are using outside consultants to assist with IT and security upgrades"

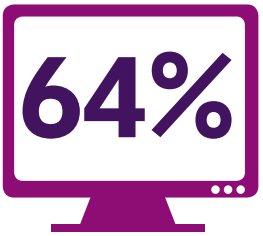
In addition, the UK government has classified cyber attack as one of the four top threats to the UK, alongside natural disasters, international terrorism and military invasion.

THE NEXT STEPS

So, what steps can firms take to mitigate the risk of cyber threat? As they try to ensure their IT is safe, many have brought in outside consultants to assist with the upgrade of information technology and security systems. This is not the cheapest option, yet it can relatively quickly move a firm into a safer position by reducing its exposure. It can also raise awareness of the risks posed, both by external hackers and even some staff.

In terms of insurance protection, firms must first distinguish between first-party cover – which protects from the loss of its own data and any business costs arising from a cyber attack or data breach – and third-party cover, which covers any liabilities to clients or regulatory penalties. As with any insurance policy, the more attractive your risk profile – demonstrated by a strong commitment to IT security – the better the premiums available to you in the market.

As this report was being compiled, Grant Thornton published new research estimating the costs of cyber crime in the UK to be an eye-watering £27 billion annually. It also estimated 80% of attacks could be prevented through simple 'network hygiene'. Proof, if any were needed, that investment in a meaningful cyber-security strategy could save law firms millions in the long run.



of law firms surveyed are planning a major technology upgrade (source: Grant Thornton)

The issue of cyber security is creeping up the UK law-firm agenda

PHOTO: ALAMY

Conclusion

There can be no doubting that the legal sector is one of the most successful, profitable and globalised business groupings ever seen in the UK. With the top 100 firms alone posting revenues in excess of £20 billion, and with hedged, counter-cyclical practices that can maintain strong profitability through good and bad times, the sector continues to deliver impressive financial results that are the envy of many other industries. However, the model that has served both clients and practitioners well for hundreds of years has been transformed in recent times. A big opportunity presents itself to those that can demonstrate the innovative management thinking, flexible staffing levels and nimble strategic decision-making needed to outstrip the pack.

Those firms that remain wedded to the old model of fixed and bloated cost bases, low utilisation and traditional pricing methods will undoubtedly struggle to compete in this new world era. Collaboration with other service providers in, for example, back office, due diligence and document-production areas is crucial as firms work alongside and not in competition with emerging legal entities.

New value propositions for clients, and finding ways of offering more than just execution-based legal advice is also key. Firms with a clear brand identity and that have a point of differentiation in the market will find it easier to grow income and profitability in what is still an over-lawyered market, beset by a decreasing number of instructions. An entrepreneurial, forward-thinking mindset will allow them to identify opportunities ahead of the crowd, and ensure that, in both the domestic and global market for business services, the UK legal profession continues to lead from the front.

“An entrepreneurial forward-thinking mindset will allow firms to identify opportunities”

PHOTO: ALAMY

A visual summary of the legal market – 2015

Income Growth

6.8%
The amount income grew in the top 100 UK firms in the first quarter of 2015 (source: Deloitte)

13.6%
Revenues rose for mid-tier firms (those ranked 51 to 100 in the study)

Borrowing and Lending

Long-term borrowing has increased by 28% over four years. Up from £5.75 billion in 2010 to £7.3 billion in 2014

Shorter-term lending, such as overdrafts has reduced from £2.4 billion in 2010 to £1.8 billion in 2014

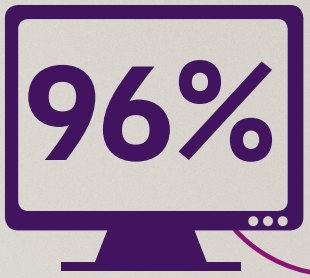
Lock-up

64% expect average debtor days to **SHORTEN**

16% expect average debtor days to **LENGTHEN**

84%
of firms interviewed do not plan to pay out profit any faster to partners

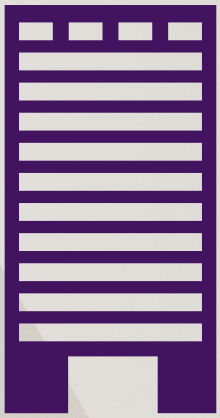
Technology



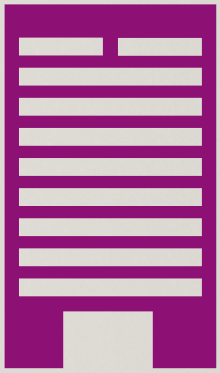
96% of respondents said they saw IT systems as a source of competitive advantage in the legal profession

7.6% of costs is for technology spend

Real Estate

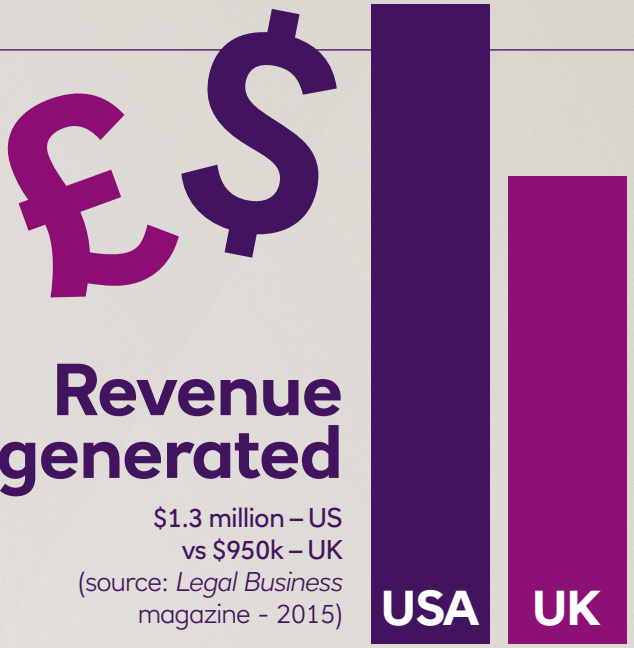


92% of firms say quality of workplace impacts employee performance



84% say quality of workplace enhances productivity

UK vs US



Revenue generated

$1.3 million – US
vs $950k – UK
(source: *Legal Business* magazine - 2015)

US firms account for more than

£2 billion

of revenue in the UK market
(source: *Legal Business* magazine – financial year 2014/15)

Cyber Security

1/5

Number of respondents who have been a victim of cyber security

Estimated number of cyber attacks that could be prevented through simple 'network hygiene' (source: Grant Thornton – 2015)

80%

SOURCE: NATWEST LEGAL INSIGHT SURVEY (2015)

Want to know more?

If you have any comments on the contents of this report or would like to have a discussion on any aspect of the legal profession more generally please contact:

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