PMI JUMPS IN SECOND QUARTER
Demand, Rates, Productivity All Rise

Following an unexpectedly soft first quarter, the large law firm market rebounded strongly in the second quarter. Demand, rates and productivity all showed marked improvement. The Thomson Reuters Peer Monitor® Economic Index (PMI) jumped 10 points to 62, reflecting the strong market performance during the quarter.

Demand rose 1.4% – the best quarter since 2012. That was more than enough to reverse the decline in the first quarter and pull year-to-date demand up 0.4%. By comparison, demand growth for the first six months of both 2016 and 2017 was a tepid 0.1%.

However, demand growth was somewhat uneven. Am Law 100 demand rose 3.2% in the quarter, while Midsize was up 1.8%. Am Law Second Hundred, meanwhile, fell 0.2% – this marks its sixth consecutive quarterly decline. Year-to-date, demand is up 1.8% for Am Law 100, 0.3% for Midsize, while Am Law Second Hundred is down 0.2%.

Worked rates were up by an average of 3.4% – the high Q2 growth in several years.

Productivity showed major improvement in second quarter, resulting from positive demand growth and restrained headcount growth.

DEMAND BY PRACTICE AREAS
Most major practice areas were stronger in the second quarter.

Litigation rose 2.2% and is now up 0.6% year-to-date. This is the first time since 2012 that litigation has been positive at the mid-point of the year. Also, litigation was positive for all three market segments in the second quarter, a remarkable achievement for a practice that endured several years of persistent underperformance.

Also noteworthy is that through the first six months of the year, strength in litigation has been spread across the market segments. Am Law 100 was up 1.6% in the second quarter although it is only flat year-to-date. Am Law Second Hundred rose 0.8% and is up 1.1% year-to-date. Midsize gained 3.5% and is up 1.3% year-to-date.

Transactional practices were mixed. Corporate work gained 2.1% and is up 0.9% year-to-date. Real estate dropped 0.5% and is down 0.7% year-to-date. Tax work fell 1.2% and is down 1.0% year-to-date.

Patent litigation dropped 2.9% and is down 3.6% year-to-date. Patent prosecution was down 0.3% and is down 1.4% year-to-date.

Labor and employment had its third consecutive quarter of growth, gaining 1.4% and is up 1.5% year-to-date. Bankruptcy was down 4.6% and is down 5.5% year-to-date.

PERFORMANCE BY MARKET SEGMENT
Am Law 100 continues to be the strongest market segment with the highest demand growth, rate growth and productivity, both in the second quarter and year-to-date. Midsize was also positive for all three key indicators in the second quarter and year-to-date, but not as strongly positive as Am Law 100. Am Law Second Hundred, meanwhile, has been negative for both demand and productivity so far this year, and rate growth trails the other two segments.

Breaking down the Am Law 100, Am Law 1-50 is seeing slightly higher average rate growth, while Am Law 51-100 has been experiencing slightly higher demand growth.

1The 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.
RATES
Worked rates grew 3.4% in the second quarter and are up 3.3% year-to-date. It was the fourth consecutive quarter where average rate growth was three percent or higher. Am Law 100 rates were up a robust 4.2% and are up 4.3% year-to-date. Midsize rates grew 3.0% in the quarter – only the second time Midsize has reached the three percent mark in more than five years. Midsize is up 2.9% year-to-date. Midsize rate growth has been slowly rising over the past two years – in Q2 2016 rate growth was only 2.1.
Am Law Second Hundred, however, has seen generally flat rate growth over the past several quarters, up 2.9% in the second quarter and up 2.8% year-to-date.
Collected realization against worked rates rose slightly to 89.5%. Cash collections were up 5.0% in the second quarter, compared with 2.5% in the same period a year earlier.

EXPENSES
Direct expense growth ticked up slightly to 2.8% but has generally been trending downwards since Q1 2017. The spike in late 2016 and early 2017 was largely a result of bumps in salaries for stating associates, and since then, salary-based expense growth has tempered slightly.
Indirect expense growth, meanwhile, rose to 2.6%. Since bottoming at a mere 1.7% in the second quarter of 2017, the rate of growth for indirect expenses has accelerated for four straight quarters.

PRODUCTIVITY
Productivity gained 0.9% in the second quarter. Productivity has now been positive in two of the last three quarters, following years of steady decline. Year-to-date, productivity is basically flat, down 0.1%.
Lawyer headcount growth continues to slow, but primarily among Midsize firms. Midsize headcount growth has slowed sharply since early last year. In the second quarter, headcount actually contracted 0.1%. Year-to-date, it is up only 0.2%.
Midsize is to some degree catching up with Am Law 100 and Second Hundred, both of which began slowing their hiring earlier. Headcount growth for those segments reached near-term lows last year, and since then have rebounded slightly.
Am Law 100 headcount grew 1.6% in the second quarter and is up 1.3% year-to-date. Am Law Second Hundred was up 0.4% and is up 0.6% year-to-date. The attorney replenishment ratio was 1.15 – slightly lower than the 1.18 a year earlier.

2018 IS STRONGER HEADING INTO THE SECOND HALF
The impressive second quarter results more than made up for a tepid first quarter. But the market has been perplexingly volatile in recent quarters. 2017 ended with one of the most positive fourth quarters in recent years. 2018 began with a surprisingly weak first quarter in what is typically one of the strongest times of the year. It was followed by a rebound in the second quarter.
During the period between early 2013 and late 2017, there were no quarters where demand, rate growth and productivity all rose together. It has now happened twice in the last three quarters.

SPECIAL FOCUS
PRODUCTIVITY GROWTH ... FINALLY
Firms have been wrestling with the balance between supply and demand since the end of the financial crisis. After emerging from the recession, many firms were eager to restart hiring in anticipation of demand resuming a pattern of growth.
But after an initial surge in growth post-recession, demand growth since 2011 has largely been flat, mostly bouncing a percentage point or two on either side of the neutral line. Firms that continued to ramp up hiring often had challenges generating sufficient work to match their staffing levels, leading to steady erosion of average hours-per-lawyer.
Over the last two years, firms have done a much better job of restraining their headcount growth, helping to bring supply and demand into a better balance. This trend first took hold in 2016 among the Am Law Second Hundred firms where average headcount growth slowed to less than one percent. Am Law Second Hundred even experienced a few quarters where headcount was flat or even contracted.
Averages for Am Law 100 and Midsize have similarly slowed over the last several quarters. In this most recent quarter, Midsize saw negative headcount growth, similar to what Am Law Second Hundred experienced during parts of 2016.
Am Law 100 headcount growth is still higher than the other market segments. However, stronger demand growth is enabling the segment to maintain strong productivity gains. Midsize headcount growth has been largely flat this year, enabling productivity to rise as demand rebounded in the second quarter.
However, productivity is declining for Am Law Second Hundred. Weak demand growth for the segment continues to drag down productivity despite efforts to reduce headcount growth.
Overall, the large law firm market has managed to finally break through to resume productivity growth. Continued gains will depend on firms maintaining discipline in headcount to ensure that supply remains in better balance with demand moving forward.

For more information on the PMI, and how Peer Monitor can help your firm successfully manage through today’s economy, please contact Brent Turner at 651-848-8712 or brent.turner@thomsonreuters.com, or visit the Peer Monitor website here.

For further discussion on strategies, contact your Peer Monitor consultant.