Featured White Paper

2024 Client Advisory

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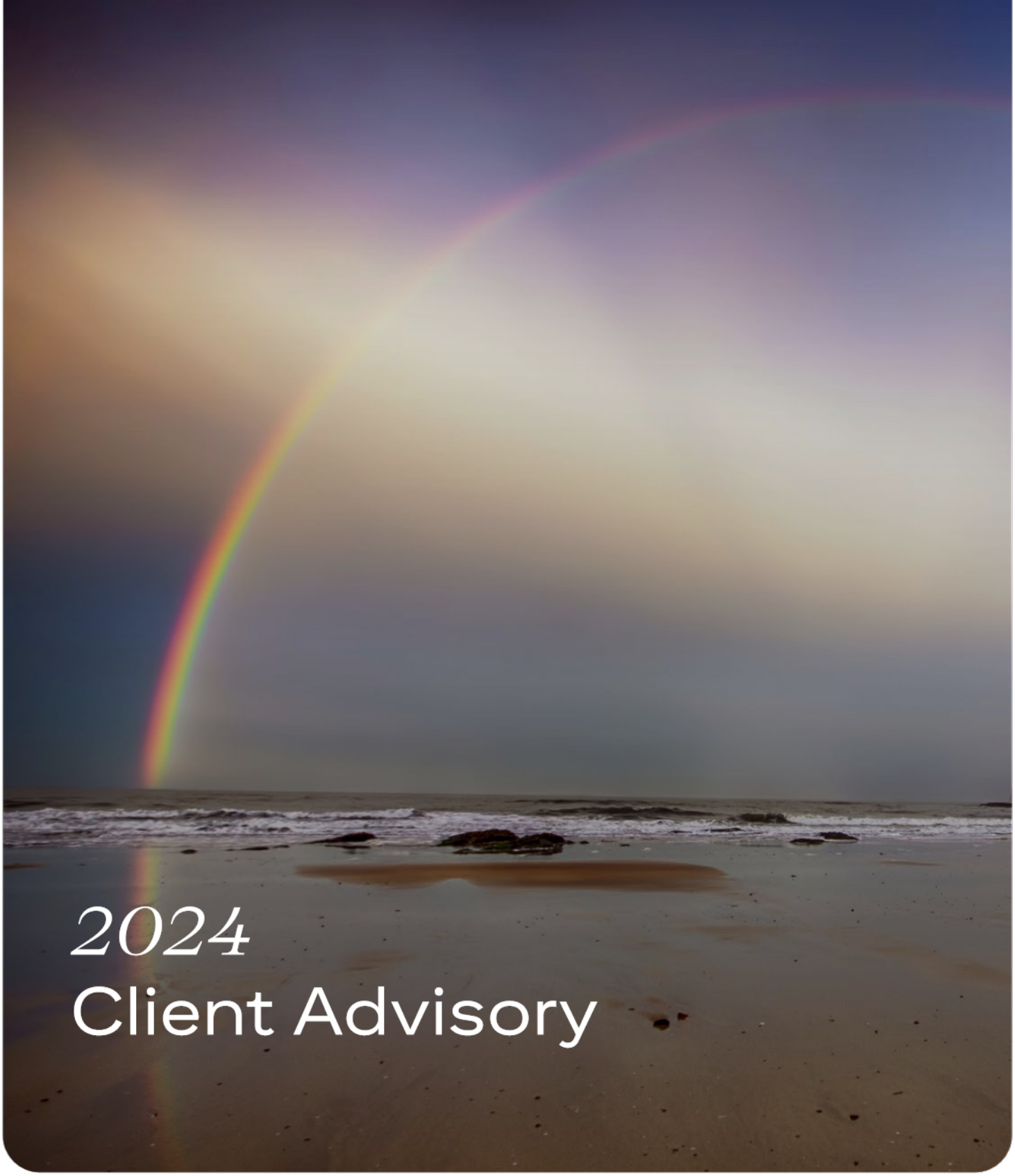


2024 Client Advisory

Citi Global Wealth at Work

HILDEBRANDT CONSULTING LLC

We are pleased to present our 2024 Citi Hildebrandt Client Advisory, now in its 16th year. We are grateful to the many of you who share your law firm industry insights with us each day and we thank you for your ongoing support.

We hope you find this valuable and welcome your feedback.

Gretta Rusanow
Managing Director and Head of Law Firm Advisory Services,
Citi Global Wealth at Work

Brad Hildebrandt
Chairman
Hildebrandt Consulting LLC

Part I. The legal market in 2023

Given the high likelihood of a recession in 2023, we wrote in our 2023 Citi Hildebrandt Client Advisory that we expected a challenging year, but that clients need lawyers in good times and bad. While it was hard to predict what would happen in the following 12 months, we expected that firms with a tilt toward down cycle practices would fare better than those who are heavily dependent on M&A and capital markets practices. This is indeed what we have seen so far this year.[1]

Industry performance: 9mo'23 vs. 9mo'22

Revenue growth for the first nine months of 2023 was 4.8% on average for the industry. While demand was down and the collection cycle continued to lengthen, average lawyer rates increased by 8.2%.

Measured against the challenging year of 2022, demand for the first nine months of 2023 was down 0.7% compared with the same period last year – with the decline moderating throughout the year. Demand levels depended largely on practice mix. While large cap M&A and capital markets practices remained challenged, there were a number of busy practices – litigation, regulatory and investigations, funds/investment management, bankruptcy and restructuring, and intellectual property. We also heard from many firms that small- to mid-market cap M&A practices were active.

Meanwhile, the collection cycle lengthened by 5.0%. Along with a decline in demand, this persistent trend of an ever-lengthening collection cycle has challenged firms' revenue and profit growth for almost two years now. To some degree, the lengthening is driven by inventory related to matters not yet closed, demonstrated in the 10.6% growth in unbilled time, some of which might be written off by year-end. We also see the impact of practice mix. As just one example, funds-related work tends to have a longer collection cycle, affecting firms who have seen strong funds/investment management activity this year. And we continue to see the use of e-billing systems as a major driver of the delay in bill payment. Meanwhile, we have heard that the current strong interest rate environment has caused some law firm clients to take longer to pay their bills, as they focus on holding on to their cash for longer. By the end of September, we saw 9.4% growth in accounts receivable and 10.0% growth in total inventory.

Meanwhile, total lawyer headcount growth continued as demand declined, resulting in a 3.1% drop in average lawyer productivity. Headcount was up 2.9% – partly due to the significant decline in attrition this year. We would also note that the level of headcount growth has moderated throughout the first nine months of 2023. While there have been a few announcements of isolated layoffs, we have heard from our clients that they managed headcount by moving lawyers into busier practices, and for the

[1] Our analyses and projections are based on data collected from a sampling of primarily US-headquartered law firms by Citi Global Wealth at Work, as well as conversations with law firm leaders. Sources include the "Citi Annual Survey Database" of 213 US- and UK-headquartered, including 44 Am Law 1-50 firms, 37 Am Law 51-100 firms, 57 Am Law Second Hundred firms, and 75 additional firms; 194 firms from the "Citi 9mo'23 Flash Survey," including 44 Am Law 1-50 firms, 38 Am Law 51-100 firms, 51 Am Law Second Hundred firms and 61 additional firms; the "Citi Law Firm Leaders Survey" of 56 large firms headquartered in the US, UK, China and India; and the "Law Firm Leaders Confidence Index" which reports the forward-looking opinions of law firm leaders from 146 firms.
Percentages used in the Figures may not add exactly to 100% due to rounding.

most part, through tougher performance reviews. This latter action has been the more common one – perhaps unsurprising given the rush to find and hold on to enough lawyers to cope with the surge in demand during 2021. During that spike in demand, some performance issues may not have been dealt with. In the much different economic environment seen this year, it made sense for firms to address those underperformance issues.

We saw equity partner headcount growth of 0.9%, lower than the 1.2% growth we reported for the same period in 2022 but still higher than the historical norm of essentially flat growth. This signals that firms continue to invest in their growth, as discussed later in this report.

With total lawyer headcount growth outpacing equity partner headcount growth, leverage was up 2.7% for the first nine months of 2023. Though the demand environment remains challenging for some, many firms believe that they are well positioned for a rebound in transactional work in 2024.

Expense pressure remained strong in 2023, driven by the inflationary pressures on firms' operating expenses. Total expenses were up 4.8% for the first nine months of 2023, driven by 7.8% growth in operating expenses. Firms have had to absorb higher costs associated with technology, insurance, and professional staff salaries. We also saw more partner retreats and increased investment in business development during the year. On the positive side, however, total expense growth has moderated throughout the year. Also, we have seen only modest compensation expense growth of 1.6% – a reversal of the strong compensation expense pressure seen in 2021, and for some firms, through the first quarter of 2022. For firms who pay bonuses during the first quarter, lower bonuses this year in the wake of low productivity were the primary driver of the more modest compensation expense pressure this year.

Looking ahead to the full year results, strong inventory levels for the first nine months place firms in a good position for year-end collections, even with an anticipated increase in unbilled time write-offs relating to uncompleted 2022 deals. That said, if firms are able to collect on those strong inventory levels, and we continue to see a moderation in expense pressure, we expect mid-single digit revenue growth and modest profit growth.

Performance by revenue segment

Looking at these nine-month results by law firm revenue size, most of the demand decline has been concentrated among Am Law 1-50 firms, consistent with 2022. For this segment, demand for the first nine months of 2023 was down 1.2% on average, illustrating their comparatively heavier dependence on capital markets and large cap M&A work. Am Law 1-50 firms have also seen the strongest growth in total lawyer headcount (up 3.3%) and the steepest drop in productivity (down 3.6%). This segment has also seen the strongest investment in equity partner headcount (up 1.4%), illustrating the growth mindset of many large firms. Revenue growth of 5.2% outpaced expense growth of 4.9%, while inventory for the first nine months was up 11.7%. This strong build up in inventory is due in part to a 6.1% lengthening of the collection cycle. However, if firms are able to see an acceleration in the collection cycle during the fourth quarter, we could see strong revenue growth for a number of large firms.

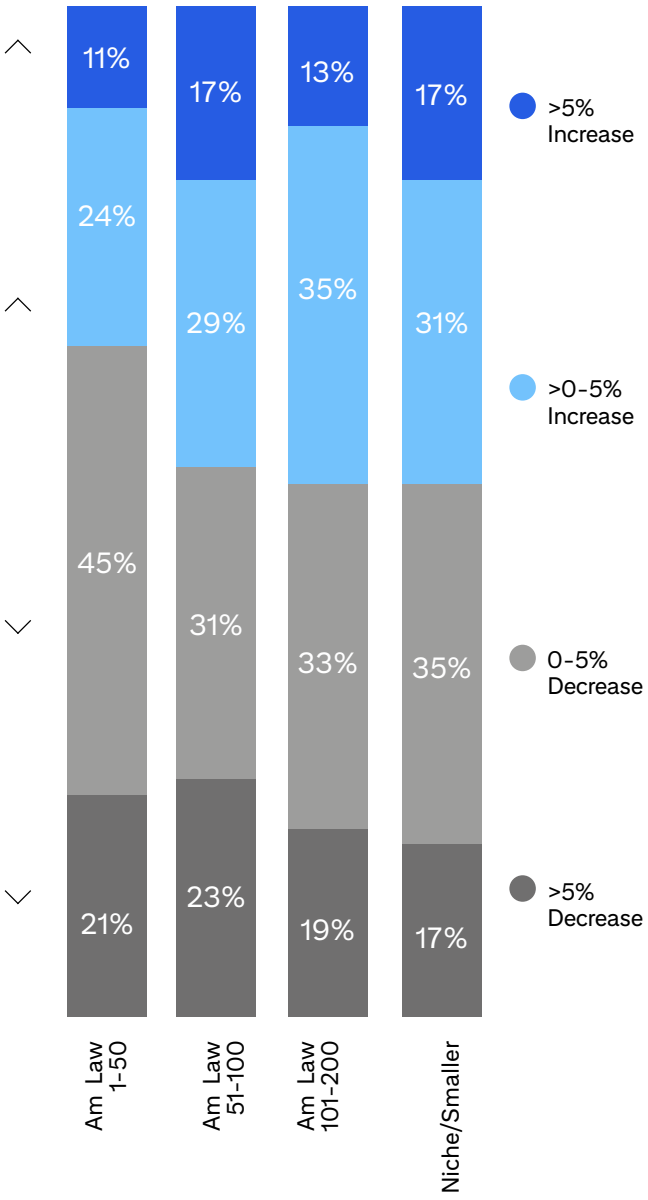
Other Am Law 200 segments have had a better demand experience so far in 2023, with demand either flat or only slightly down. This is in large part due to their broader practice mix and illustrates the strong activity we have seen in litigation, regulatory and investigations, mid-market cap transactions, and for some firms, bankruptcy and restructuring. That said, revenue growth was up modestly for the first nine months of 2023 and trailed strong expense growth, causing margin pressure. With 7.2% and 7.9% growth in inventory for Am Law 51-100 and Second Hundred firms respectively for the first nine months, these firms could reverse that margin pressure by year-end if they see a strong collections push during the fourth quarter.

Among firms outside of the Am Law 200, we saw slight demand growth during the first nine months of 2023. This was also the only market segment to see a shortening of the collection cycle. Despite these favorable conditions, revenue growth was modest and trailed strong expense growth, creating margin pressure. With 2.2% growth in inventory for the first nine months, we expect a continued push for collections through year-end to reverse this margin pressure.

Industry demand dispersion: 9mo'23 vs. 9mo'22

Behind the averages, there was wide dispersion in the performance of individual law firms across all segments of the industry – FIGURE 1. The level of dispersion differed across the segments of the industry by size. Consistent with last year, and in contrast to the trend we saw for many years prior, the largest firms trailed other segments in demand performance – with 66% of Am Law 1-50 firms seeing a drop in demand through the first nine months of this year. This lagging performance is largely attributed to the tough large-cap M&A and capital markets environment disproportionately affecting large firms. Conversely, the higher proportions of firms reporting demand growth within other industry segments illustrates their broader practice mix. That said, no industry segment saw a majority of firms report demand growth.

Figure 1: Demand Dispersion by Revenue Segment 9mo'23 vs. 9mo'22



Source: Citi Flash Survey © Citibank, N.A. November, 2023

Part II. Looking ahead to 2024 and beyond

A. Growth opportunities and challenges
B. The likely impact of generative AI
C. Key trends to watch in 2024

A. Growth opportunities and challenges

Looking ahead to 2024 – and beyond – law firms face five key challenges. These are: achieving growth in a challenging macroeconomic and geopolitical environment; attracting, retaining and developing talent; navigating the challenges of a flexible work model; adapting to rapid developments in artificial intelligence; and managing cost inflation and pricing pressure.

The Citi Law Firm Leaders Survey reveals that large firms are particularly concerned with achieving growth in a volatile geopolitical climate and macroeconomic environment. That said, they continue to maintain a growth mindset.

Firms plan to expand selectively. They are focused on specific practices, including bankruptcy, litigation, private equity, digital/cyber and private capital. Firms will look to expand in these practices and others by attracting and retaining talent. As they pursue growth, they will look to increase their share of existing clients' legal work in addition to attracting new clients. In order to expand their market share, firms will continue to focus on improving brand awareness, to attract both talent and clients.

When it comes to attracting and retaining partner talent, competition among firms to attract and retain the best is expected to continue. We believe that one factor fueling the intense lateral market over the past few years has been the excess of remote work, as lawyers didn't feel as connected to their firms. And while we don't anticipate an intense war for associate talent, developing associate talent is expected to remain challenging going forward, especially as firms continue to navigate the new flexible work model.

In a post-pandemic world, changes to working patterns remain ongoing; and we wouldn't be surprised to see more firms adopt a four-day week. We believe that in-office time aids associates in their development, as they benefit a good deal from regular in-person interaction with senior associates and partners. Having people in the office more frequently also serves to strengthen the culture of the firm – which is critical in an active lateral market.

The rapid developments in AI in 2023 have also caused firms to focus on how they will adapt to generative AI in the coming years. We expect that firms will continue to focus on how best to leverage generative AI and technology in general to work more effectively. There will be two parts to this – (1) to improve business processes within the firm, and (2) to deliver legal services more efficiently. We also expect that some firms will look at creating revenue streams based on generative AI.

Finally, given the expense pressure felt over the past two years, we expect that firms will continue to focus on ways they can manage the higher costs of running a law firm. And for some, there is an expectation of pricing pressure in the year ahead.

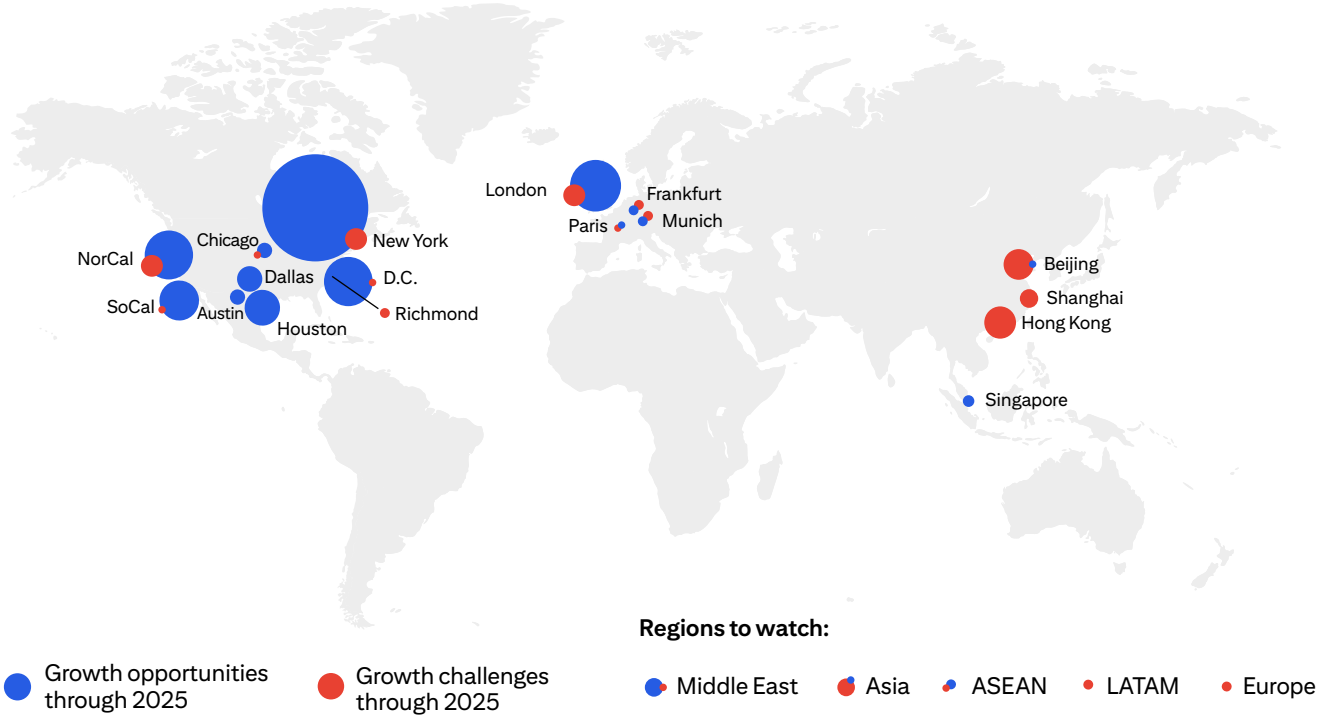
Despite these challenges, we are optimistic about 2024. We expect continued strong activity levels for the high-performing practices of 2023 and we are optimistic about transactional practices. At the time of writing, Citi's view is that we are experiencing a series of "rolling recessions" as we head into 2024, but these will "roll out" in the coming year. There are a number of positive signs that interest rates will start to decline in 2024. The rate of inflation is moderating and employment growth is slowing. We have also seen bond yields trending lower recently and the market is predicting Fed rate cuts in 2024. Meanwhile, corporate profits are rebounding. While we can expect to remain in a high interest rate environment in 2024, we anticipate a rebound in transactional practices when market volatility settles.

Growth opportunities and challenges by region

We expect to see the US continue to be the major source of demand growth through 2025 and likely beyond. Based on the Citi Law Firm Leaders Survey – FIGURE 2, when it comes to growth opportunities, four out of the five major markets are found within the US, namely New York, California, Washington DC, and Texas. Of the US markets, New York remains the primary growth market, with California continuing to strengthen. Beyond these four major markets, we are also seeing growing interest in Chicago.

Outside the US, the biggest growth opportunity is London, which we expect to remain an active market through 2025 and beyond. However, Europe is set to remain challenged, with firms describing mixed feelings about the growth opportunities in Frankfurt, Munich and Paris. Europe has battled with an energy crisis and the effects of Russia's invasion of Ukraine – both factors which have left it less stable than we've seen in recent times.

Figure 2: Growth Opportunities and Challenges by Region Through 2025



Source: Citi Law Firm Leaders Survey © Citibank, N.A. July, 2023

With the relationship between the US and China becoming strained in recent years, some firms have departed from mainland China – and are instead now looking at ASEAN countries to build a presence, with many firms already established in Singapore. Firms expect to face ongoing challenges in Beijing, Shanghai and Hong Kong in particular. That's a theme that emerged during the pandemic, as a result of particularly stringent lockdown restrictions in those regions – although firms were already retreating from Hong Kong in the wake of political unrest.

In contrast, there is growing interest in the UAE – which is encouraging firms to consider the Middle East more generally. While the current fragile geopolitical environment in this region may give firms pause, the UAE is attracting international wealth and investment by offering advantageous tax systems and favorable business laws, and by catering to affluent lifestyles.

Looking toward Latin America, the area will likely remain a challenging region for firms through 2025 and beyond. This is, in part, due to some areas of political instability across the region – alongside

the lack of inter-country business available to larger firms. Firms rarely have offices outside of their base country, which drastically limits opportunities.

Canadian and Australian firms are having a similar experience to other markets, with litigation and mid-market cap M&A busy while large cap M&A is down. An interesting development in Canada has been the growing number of US firms opening offices and building those offices by hiring laterals from Canadian firms. Time will tell how successful these expansion efforts are, and we will continue to watch this trend.

We have also seen the loosening of regulations affecting legal practice by foreign firms in India. That said, there are still restrictions to entry. While we are beginning to see foreign law firms show interest in entering the Indian legal market, we expect that firms will remain cautious about investing in this market for the time being.

Growth opportunities and challenges by practice

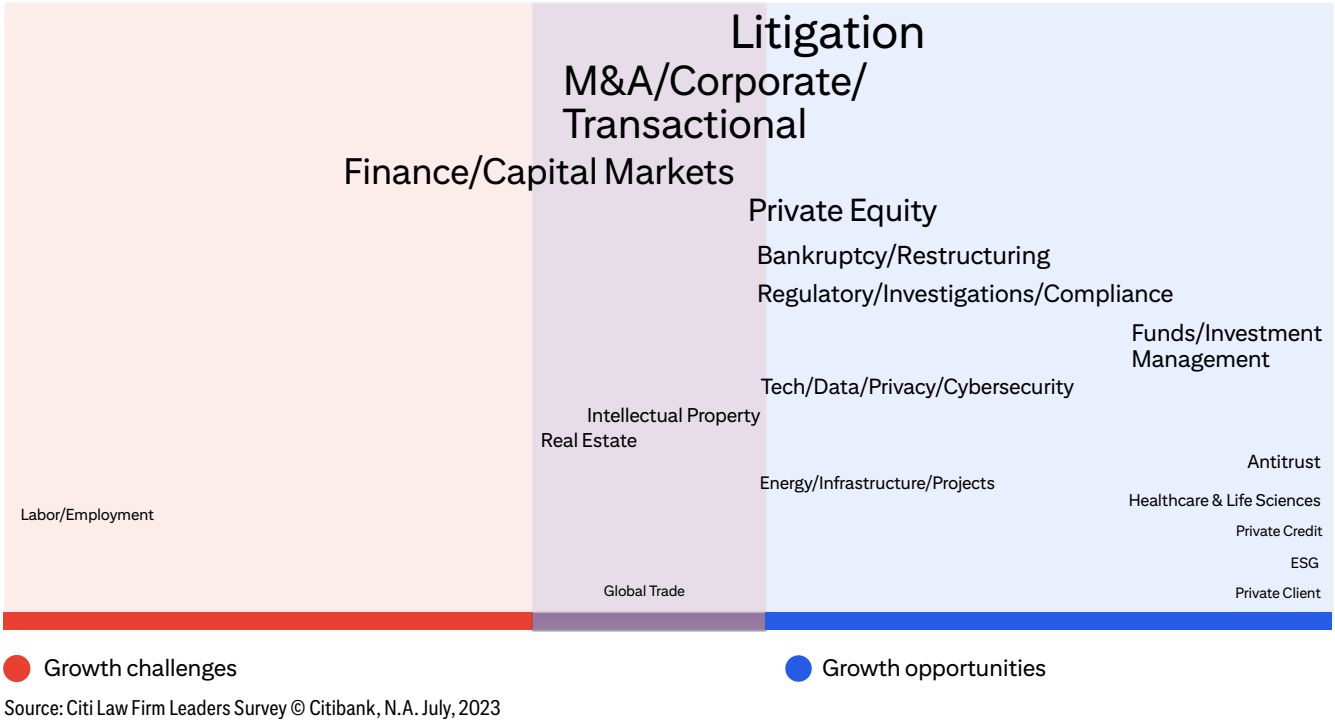
Looking at growth opportunities by practice area – FIGURE 3 – we expect to see continued strength in litigation, one of the most active practices over the past two years. Bankruptcy and financial restructuring and regulatory/investigations/compliance work have all grown in terms of opportunities and are expected to continue to strengthen through 2025, as is also the case with funds/investment management, private equity and antitrust. Growth is also expected in other practices, such as data privacy and cyber security, healthcare and life sciences, private credit and energy, infrastructure and projects.

Perhaps reflecting the experience of the past two years for many large firms, their outlook for M&A and capital markets is more mixed. While some remain concerned about what might lie ahead, a good number believe that there will be a rebound in capital markets and large cap M&A in 2024, as volatility settles.

And, while intellectual property (IP) prosecution might be challenging, IP litigation and trademark work will likely remain very active.

It is likely real estate and labor and employment practices will remain challenged.

Figure 3: Growth Opportunities and Challenges by Practice Through 2025



Source: Citi Law Firm Leaders Survey © Citibank, N.A. July, 2023

Growth opportunities and challenges by industry

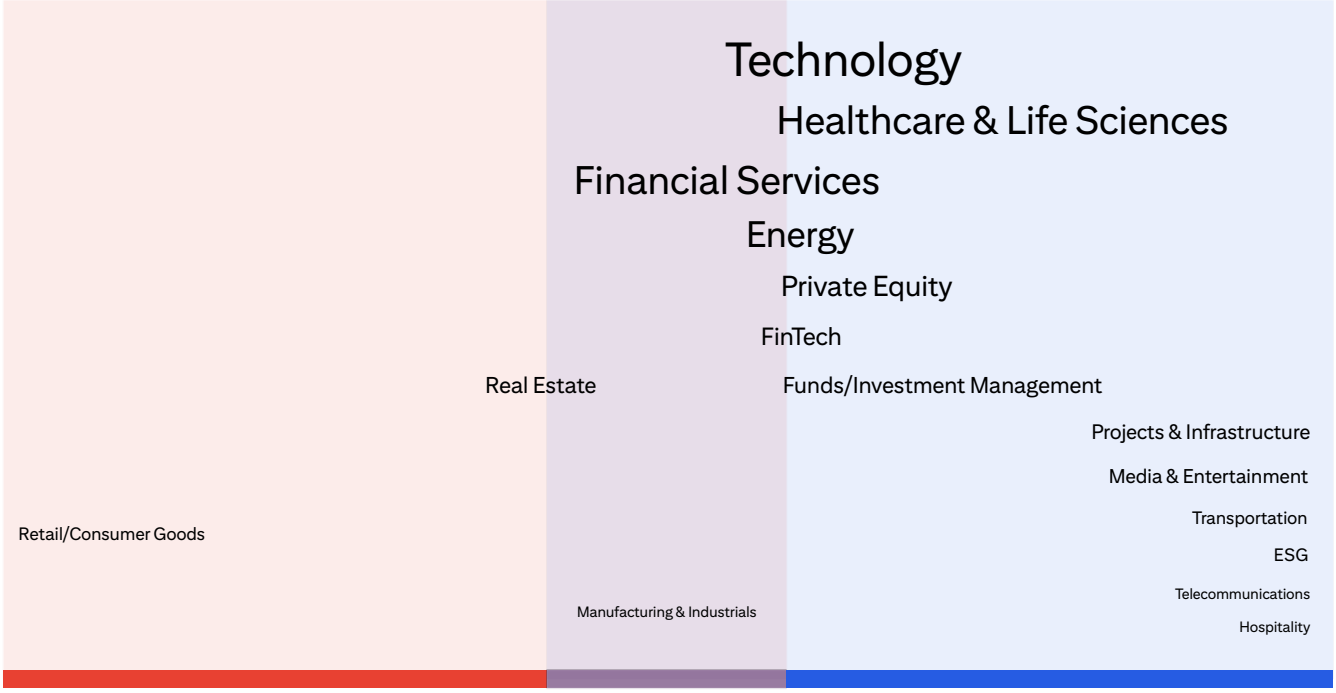
As for growth opportunities and challenges by industry – FIGURE 4 – the technology industry is still viewed as a very strong driver of legal work, as we have seen in recent years. We expect more regulatory oversight of this industry will continue to generate legal work, along with transactional activity.

We can also expect to see energy, private equity, healthcare and life sciences to continue to be growth industries for law firms.

Firms are also generally optimistic about funds/investment management and fintech, while the outlook for work generated by financial services clients is mixed.

And while there is concern about likely demand from real estate, retail/consumer goods and manufacturing clients, growth is likely to come from projects and infrastructure, media and entertainment, transportation, and hospitality clients.

Figure 4: Growth Opportunities and Challenges by Industry Through 2025



Source: Citi Law Firm Leaders Survey © Citibank, N.A. July, 2023

Growth through consolidation

We expect most growth in 2024 to come from promotions and laterals, consistent with prior years.

We also expect to see continued merger and acquisition activity, mainly among smaller and regional firms, as we have seen in recent years. The challenges of both a slow growth environment and a higher cost structure caused by inflation will no doubt drive further mergers and acquisitions among this industry segment. That said, we also acknowledge that there are many smaller and regional firms who are happy to remain as they are, and not looking to become part of a larger organization.

While there have been some mergers and acquisitions involving large firms in recent years, we haven't yet seen a significant number taking place, likely as a result of the complexity of combining large firms and the longer-term strong performance of so many.

Among large firms, the most interesting market trend going forward is likely to be the further expansion of UK-headquartered firms into the US market. With one major British/US merger already underway, it's possible we may see other UK-headquartered law firms looking to expand their footprint in the US beyond acquiring individuals or small lateral groups.

Finally, as we consider recent and future market consolidation, we have also seen some potential law firm dissolutions in the past year. Having worked on numerous law firm dissolutions over the years, we would note that while financial pressure may have been a factor, it was not the only cause. In our experience, the leading factor in those dissolutions was the large number of partner departures, signalling a loss of confidence in the future direction of their firms. In this market of intense competition for partner talent, where the strength of firm culture has been tested in a remote or flexible working environment, leadership focus on building strong and cohesive partnerships will continue to be a critical element of any firm's growth strategy.

B. The likely impact of generative AI

Where are we today?

We saw rapidly developing generative AI technology capture the attention of the legal industry in 2023. We believe that the emergence of generative AI is a positive development for lawyers and another step on the long continuum of lawyers embracing technology to improve the delivery of legal services. That said, while there is growing interest among law firms, for many it has not had much impact so far.

In the Citi Law Firm Leaders Survey, some firms described working on use cases, while a few are running active pilots. And while the developments in generative AI are recent, extractive AI capabilities are already a feature of several existing tools used by law firms, both in litigation and due diligence software.

As firms experiment with generative AI, they have also been heavily focused on identifying the associated risks. Protecting client and firm confidentiality has been top of mind. However, the risks with this rapidly developing technology are endless. Beyond protecting confidentiality, firms will need to be aware of the risks around security, accuracy and quality control. As just a couple of examples, generative AI can produce plausible sounding text that is inaccurate or created with embedded bias. To mitigate these risks, firms have been developing policies around the use of AI by both their lawyers and professional staff. Likely as a result of the unknowns, we have seen firms mostly focusing their initial efforts on using generative AI for internal processes before they address its use in client-facing work.

Meanwhile, the rapid development of generative AI has created a good deal of client advisory work for law firms. This will no doubt continue to grow.

Where might we be by 2025?

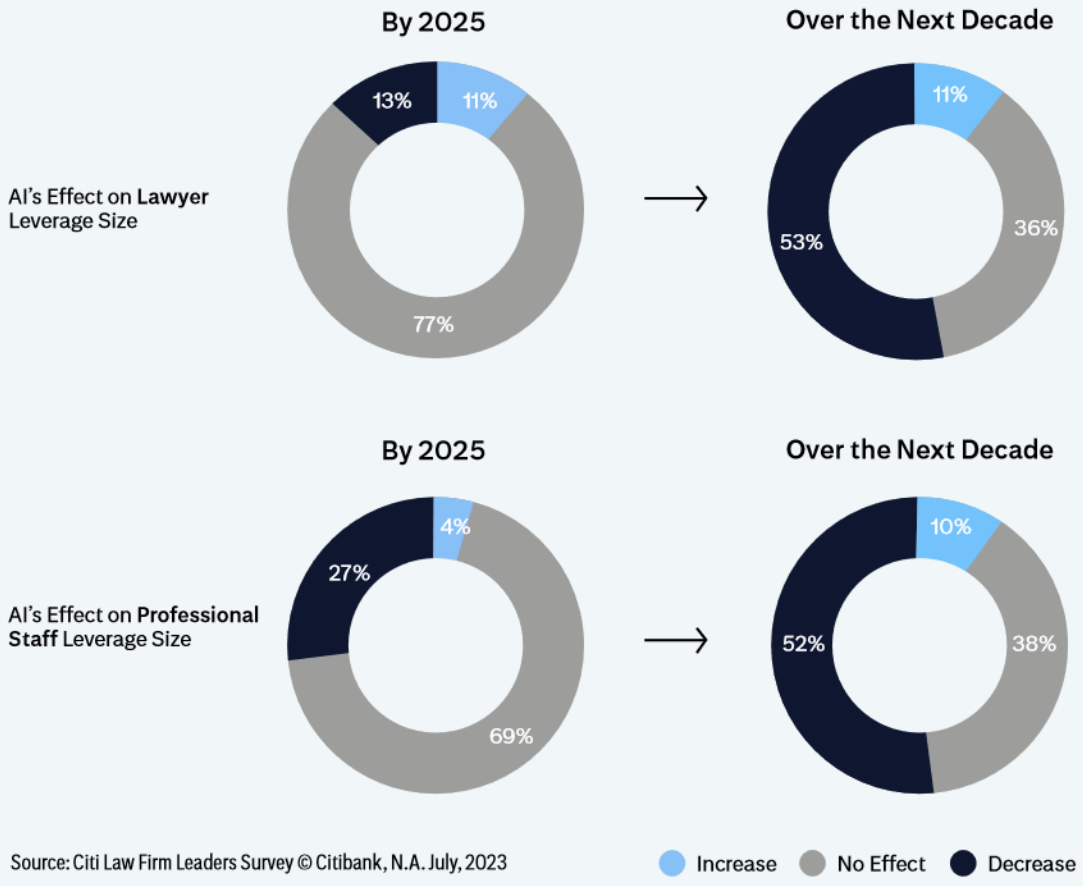
Many firms feel that generative AI will continue to have limited impact over the next two years, or that it is simply too soon to tell. For others, they expect generative AI to grow in usage as it becomes embedded into existing technology tools.

We also expect to see the emergence of some entirely new tools, which will work interoperably with the industry's existing systems. However, with the emergence of many small companies offering solutions, it's possible that we will see a shakeout of the generative AI technology industry. We would caution firms to bear this in mind as they consider which solutions to implement.

By reducing the time spent on previously time-consuming tasks, it's likely that we will begin to see the effect of generative AI on how lawyers work. This will no doubt start to affect the size and shape of leverage for some. However, only a small number of firms believe that generative AI will cause a reduction in lawyer leverage in the near term, as illustrated in Figure 5. And while some firms have told us that they expect to see fewer junior associates, most large firms believe it will have no or only a minimal impact, or that it is simply too soon to tell.

Over the next two years, it is more likely that we will see generative AI have a comparatively greater impact on internal business processes at law firms. We can expect to see it used to streamline certain operations and tasks, such as billing and collections processes; conflict checking; and production of client pitches and marketing materials. As this starts to affect the way professional staff work, we can expect to see the effect on the size and composition of the professional staff leverage model. Many firms believe that within the next two years, the introduction of generative AI will contribute to the further reduction of secretaries, as well as some junior roles. Conversely, generative AI will likely be a major factor in the increased use of IT professionals and data scientists discussed later in this report.

Figure 5: The Impact of Generative AI on the Lawyer and Professional Staff Leverage Model by 2025 and Over the Next Decade



Source: Citi Law Firm Leaders Survey © Citibank, N.A. July, 2023

Where might we be in a decade?

Looking out to the next decade, we expect generative AI will have a significant impact on the legal industry. While on one hand, it is arguably too soon to tell, the speed of technological development cannot be ignored, and the potential repercussions are likely to be immense.

One critical factor that must be considered is the effect of regulation on firms as a result of the growth of generative AI; with governments around the world likely to introduce new regulation to counter emerging threats from AI-powered automation.

As seen in the Citi Law Firm Leaders Survey, large firms also expect that over the next decade we will see widespread adoption of generative AI. We will see greater efficiencies in the delivery of legal services and in the law firm operating model. While less routine work will likely mean fewer junior associates and contract lawyers for many firms, it may not necessarily mean a reduction in the size of lawyer leverage for all. As Figure 5 illustrates, while more than half of large firms expect generative AI to drive a reduction in lawyer leverage, 36% of large firms expect that it will have no effect at all.

And while many large firms believe there will be fewer junior associates, for others it is either too soon to tell or they believe that generative AI will ultimately have no effect on the composition of their lawyer leverage.

In our view, generative AI is likely to affect firms with high leverage handling large amounts of commodity-type work more so than firms that focus more heavily on partner and senior lawyer expertise.

We also expect to see new lawyer skills and multi-disciplinary fee earner roles, with the most obvious being the intersection of lawyer and data scientist. Firms will also need to consider how they approach recruitment and lawyer development, to ensure they futureproof their lawyer leverage models. Law schools, too, will face the challenge of integrating the use of generative AI into law-school education.

As for the longer-term impact of generative AI on the size of professional staff leverage models, more than half of large firms believe that it will lead to a reduction in size over the next decade. Still, it's worth noting that 38% of large firms believe it will ultimately have no impact.

And while some firms expect generative AI to have no effect on the composition of their professional staff leverage, or that it's too soon to tell, more firms anticipate a widespread reduction in library/research staff along with further reductions in secretaries and junior roles over the next decade. Regardless of what AI does to the size and shape of the professional staff leverage model, we can expect to see developments in the skill sets of professionals as well as lawyers, as generative AI becomes more embedded in how law firms operate.

The impending doom of lawyers has been touted each time we have seen significant technological developments. Yet history has shown that as lawyers have embraced new technology and the efficiencies it has brought, their work has become more interesting. Rather than seeing the decline of the legal profession, we have witnessed its continued growth.

As the adoption of generative AI leads to less commodity work, firms believe that it will lead to more high value strategic advisory services. We believe that the work of a lawyer is poised to become far more rewarding in the process.

C. Key trends to watch in 2024

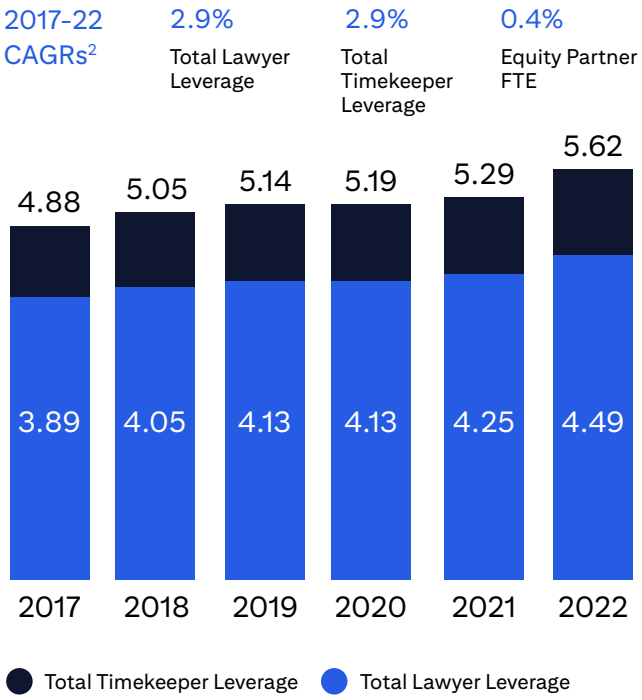
1. The growth and reshaping of lawyer leverage

A key driver of the success of some of the most profitable firms has been their focus on growing their leverage over the past decade. If we just look at the past five years, large law firms have increased their leverage at an average annual rate of 2.9% [see Figure 6]. Looking ahead, the majority of large firms expect to increase lawyer leverage through 2025, according to the Citi Law Firm Leaders Survey.

However, the size of that majority has shrunk since last year's survey, while we see growth in the proportion of firms expecting to keep the size of their leverage as is. 62% of large firms expect to increase their lawyer leverage by 2025 (down from the 77% who projected in mid-2022 they would grow their leverage by 2024). The reduction in expected leverage increases no doubt reflects the challenging environment law firms have experienced over the past 18 months.

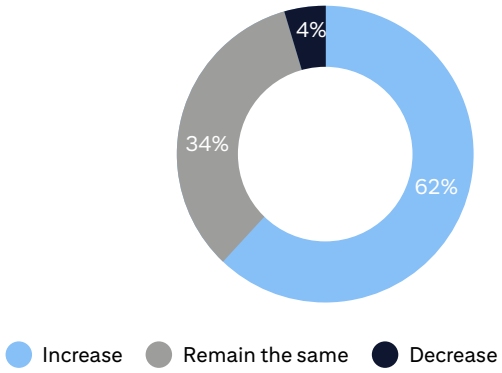
Figure 6: Leverage Growth: 2017-25

Total Lawyer vs. Total Timekeeper Leverage



Source: Citi Annual Survey of Law Firm Performance © Citibank, N.A. May, 2023
[2] CAGR = compound annual growth rate

By 2025, what do large law firms expect will happen to their lawyer leverage?



Source: Citi Law Firm Leaders Survey © Citibank, N.A. July, 2023

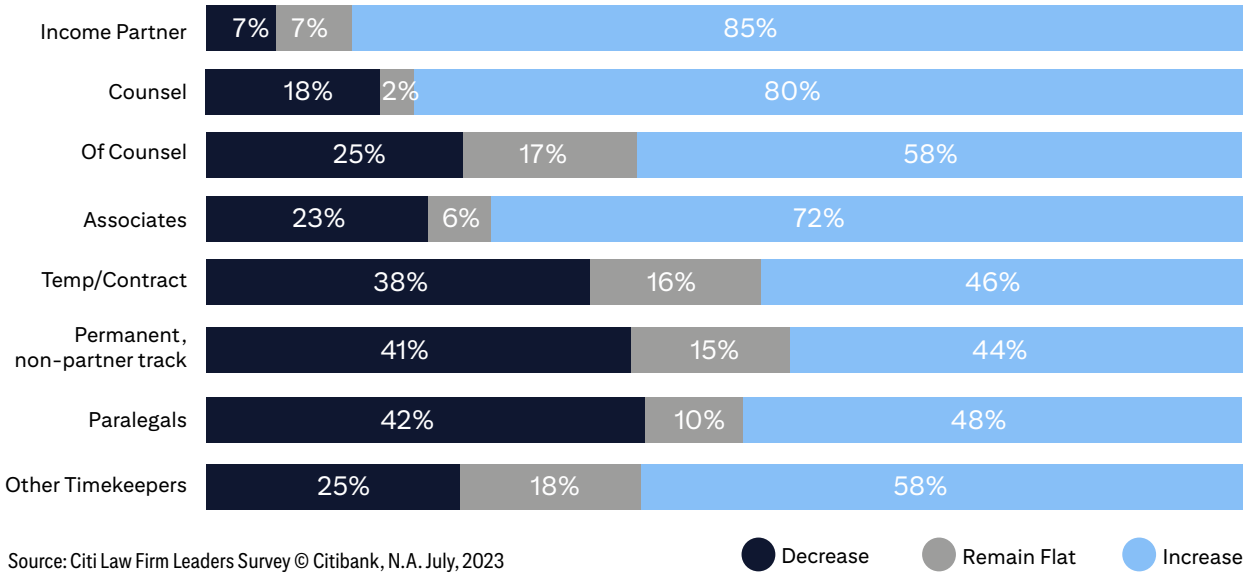
As for how firms have grown their leverage in recent years, the greatest focus has been on income partners, counsel and associates, as illustrated in Figure 7.

For large firms with income partners, 85% increased the number of income partners during 2017-22. For some, this meant the creation of an income partner category. The focus of investing in senior lawyers was also evident in the 80% of large firms who increased their counsel population.

While we note that 72% of these firms grew their associate population, it is also interesting that almost one quarter reduced the number of their associates during 2017-22, signaling varied approaches to the composition of law firm leverage models.

Further proof of large firms taking different approaches to the composition of their leverage models can also be found in the actions taken around temp/contract lawyers; permanent, non-partner track associates; and paralegals. As illustrated in Figure 7, there is wide dispersion in the number of firms who shrunk vs. increased the number of these fee earners at their firms.

Figure 7: Lawyer Leverage Growth by Category: 2022 vs. 2017



Source: Citi Law Firm Leaders Survey © Citibank, N.A. July, 2023

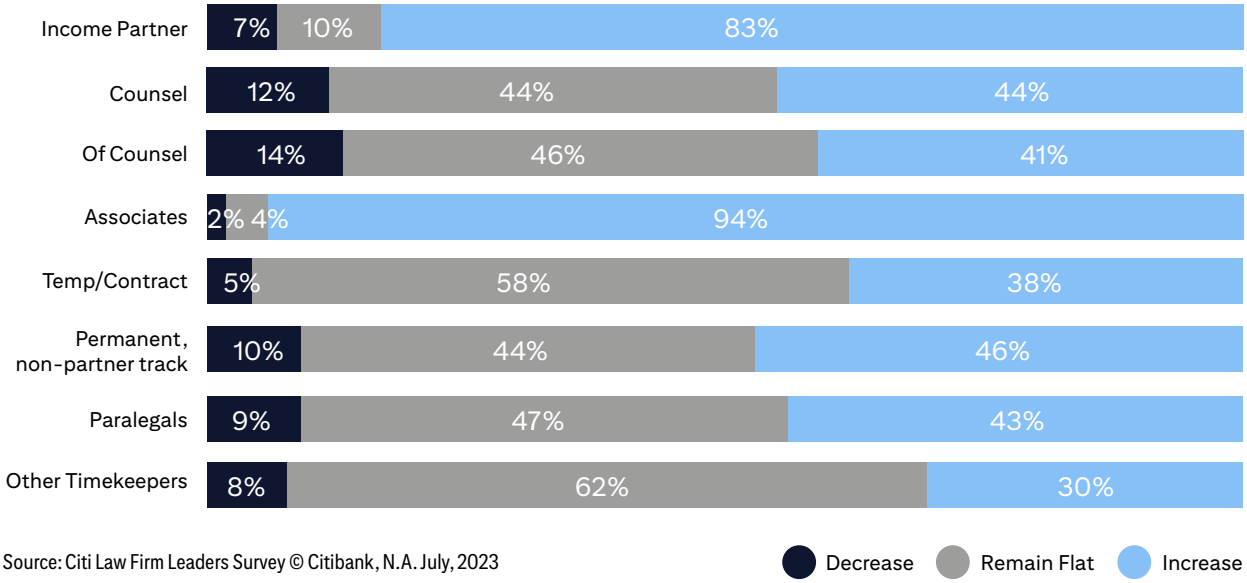
Looking ahead to 2025, as illustrated in Figure 8, large firms will focus their leverage growth on income partners and associates.

Among the most senior ranks of the leverage model, 83% of large firms expect to increase their income partner population over the next two years. This is a staggering jump from the 68% of large firms who projected growth in this population in last year's Citi Law Firm Leaders Survey, further illustrating the attention firms are giving to this population. We look more closely at the likely growth in income partners later in this report.

By contrast, large firms are evenly split on whether they will continue to increase their counsel ranks or remain at current levels.

Law firms will also likely change their approach to the use of temporary/contract, non-partner track associates and paralegals through 2025. Following the reduction of these roles by a significant number of large firms during 2017-22, we can expect to see firms either stay at their current levels or look to increase their use.

Figure 8: Projected Lawyer Leverage Growth by Category: 2025 vs. 2022



Source: Citi Law Firm Leaders Survey © Citibank, N.A. July, 2023

The most likely group to see growth is the associate population, with 94% of large firms projecting growth. However, it is unlikely to all come from increases in first year associates. Indeed, in the Citi Law Firm Leaders Survey, we already saw dispersion during 2023 in the number of large firms who increased their first year classes vs. those who saw a contraction compared with their 2022 first year associate classes. And when we look out to 2025, we see wide dispersion in law firm projections of first year class sizes. Only 39% expect to have bigger first year classes than in 2023, while 26% expect a decline. This suggests that some firms will focus their associate headcount growth on more senior associate levels over the next two years.

In another sign of firms rethinking their leverage models, the projections for summer associate classes in 2025 see 53% of large firms projecting a smaller class vs. 2023 and only 16% projecting growth.

2. Equity partner growth at more firms

Looking back over 2017-22, the majority (60%) of large firms in the Citi Law Firm Leaders Survey increased their equity partnerships, as illustrated in Figure 9. This is a shift from the even dispersion between growth and contraction that we have seen in the past, reflecting the investments in equity partners made in 2022, even in a challenging environment.

Looking ahead to 2025, we see the number of large law firms who expect to grow their equity partner ranks from 2022 levels increase to 79%. Adding equity partners is a strategy that has paid off for some of the most profitable firms, recognizing that they need scale to capture market share and retain more of their existing clients' wallet share.

Most equity partner growth through 2025 will come from promotions and lateral acquisitions. 81% of large law firms say they are highly likely to grow organically through internal promotions, while 75% are highly likely to grow through lateral acquisitions.

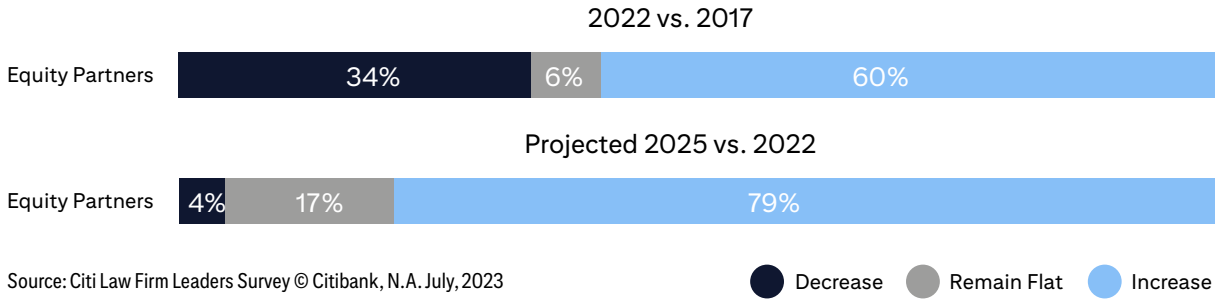
Organic growth continues to be a more reliable strategy vs. lateral growth, with 76% of large firms reporting that the partners they promoted during 2018-22 have been successful.

We also saw continued success in the lateral hiring strategies of firms. For large firms, the success rate of their lateral equity partners hired over the past five years matched that of last year's Citi Law Firm Leaders Survey at 64%.

As for the extent of guaranteed compensation for lateral partners, we see that this is more limited than is portrayed in the market, with only a small majority paying them. Moreover, these arrangements also tend to be short in duration. 56% of large law firms paid their lateral partners guarantees in 2022, up slightly from the 52% who paid guarantees in 2018. Those guarantees tended to be either one- or two-years in duration.

And while a small majority of large law firms have offered lateral partners guarantees, it is also important to note that many do not. Further, where lateral partners are given guarantees, in 43% of cases these are linked to performance, which we consider to be best practice.

Figure 9: Equity Partner Growth: 2017-25



Source: Citi Law Firm Leaders Survey © Citibank, N.A. July, 2023

3. More income partner growth

We expect to see a continued focus on income partner growth, as described earlier. We would note that this is a growing trend among some of the consistently most profitable large firms, to help retain key talent in an industry where it has become harder to make equity partner. During 2017-22, these firms grew their income partner classes at an average annual rate of 13.4%, compared with 4% average annual growth at other large two-tier partner firms. To be fair, some of these firms were either starting from a low base or creating an income partner class from scratch. That said, it highlights the focus of these firms on building an income partner class, including some firms who traditionally rejected the concept.

This trend of investing in a profitable income partner class also represents a significant departure from the unprofitable experience many firms had with an income partner population in the past. That was often the case where firms took away the equity of underperforming equity partners but enabled the partner to stay on as an income partner. In doing so, firms retained an underproductive population that received typically high salaries and, in the process, made a net-negative contribution to firm profitability.

Given this history, we note that a two-tier partnership model comes with challenges. If the income partner group is not properly performance-managed, it may result in a glut of highly paid individuals who make low or negative contributions to firm profitability.

Some critics of this trend also note that it enables firms to continue reporting strong profit per equity partner (PPEP) growth. While we have not seen this as the main motivator for firms to introduce or grow an income partner group, it does of course affect PPEP. Because of this, we also view profit per all partner (PPAP) as an important measure of profitability, along with revenue per lawyer, contribution per lawyer and net income margin.

4. Continued strong focus on both revenue and expense-related operational efficiencies

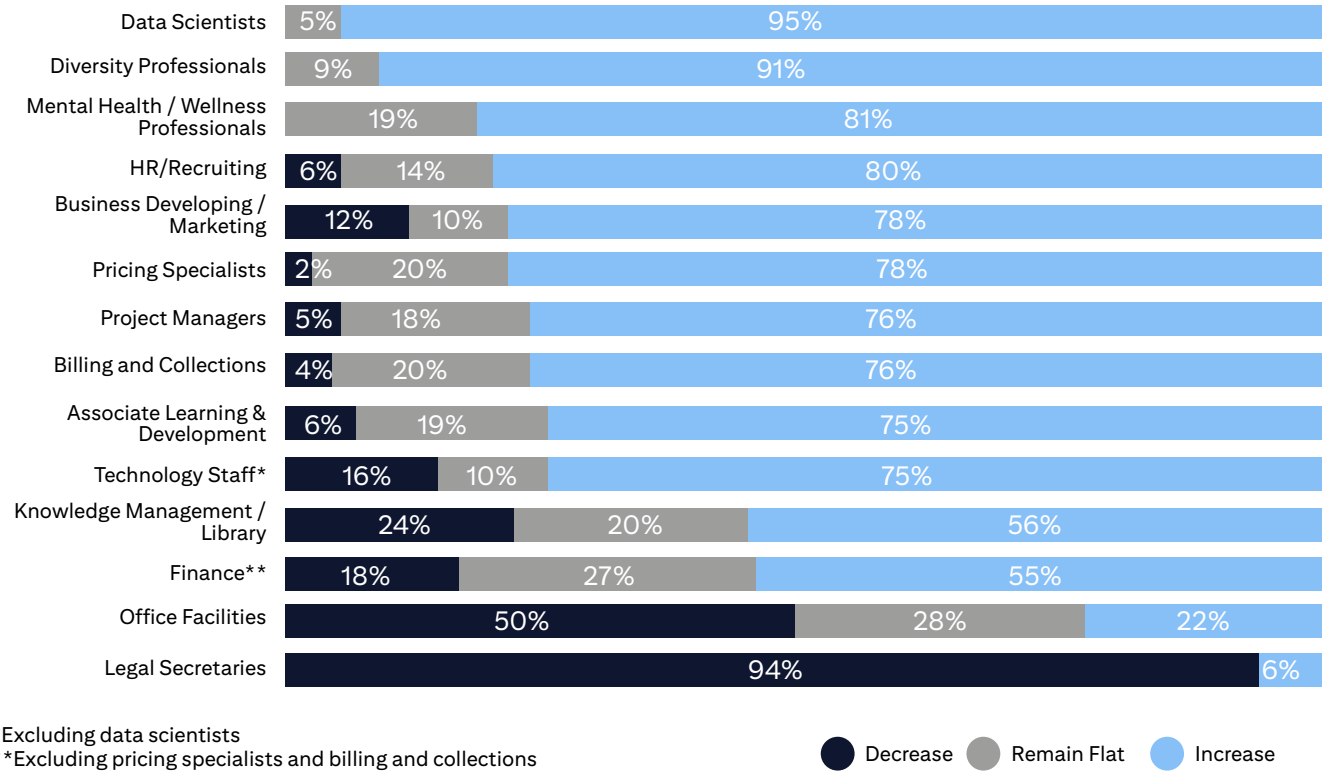
Given the demand and revenue challenges and the inflationary pressures felt over the past two years, we expect firms will continue to focus heavily on operating more efficiently. As we saw in the Citi Law Firm Leaders Survey, there are ten key operational efficiency priorities over the next two years.

I. Redesigning the professional staff leverage model
We can expect to see law firms continue to redesign their professional staff leverage model. As part of this, we are also likely to see greater use of outsourcing and shared services.

As Figure 10 illustrates, we have already seen firms make shifts in their professional staff leverage model over the past several years as they were reducing the overall size of their professional staff. During 2017-2022, we saw considerable growth across a number of business functions. Almost all large firms invested in data scientists, while a large majority added technology staff. Meanwhile, 91% of firms increased the number of diversity professionals with 81% increasing mental health and wellness professionals – illustrating the growing focus on such issues across this industry.

We also saw high proportions of firms adding HR/recruiting and associate learning and development professionals. This was unsurprising in a period of growth and active lateral movement, in which firms grappled with how to develop associates in a remote or flexible work environment.

Figure 10: Professional Staff Leverage Growth by Category: 2022 vs. 2017



*Excluding data scientists
**Excluding pricing specialists and billing and collections

Source: Citi Law Firm Leaders Survey © Citibank, N.A. July, 2023

And with the goal of increasing firm revenue and profitability, we saw a high majority of firms add to their business development/marketing teams, pricing specialists, project managers and billing and collection teams.

By contrast, we saw firms take a mix of approaches to the size and scale of their finance and knowledge management functions, though the majority of firms still increased their headcount in these areas.

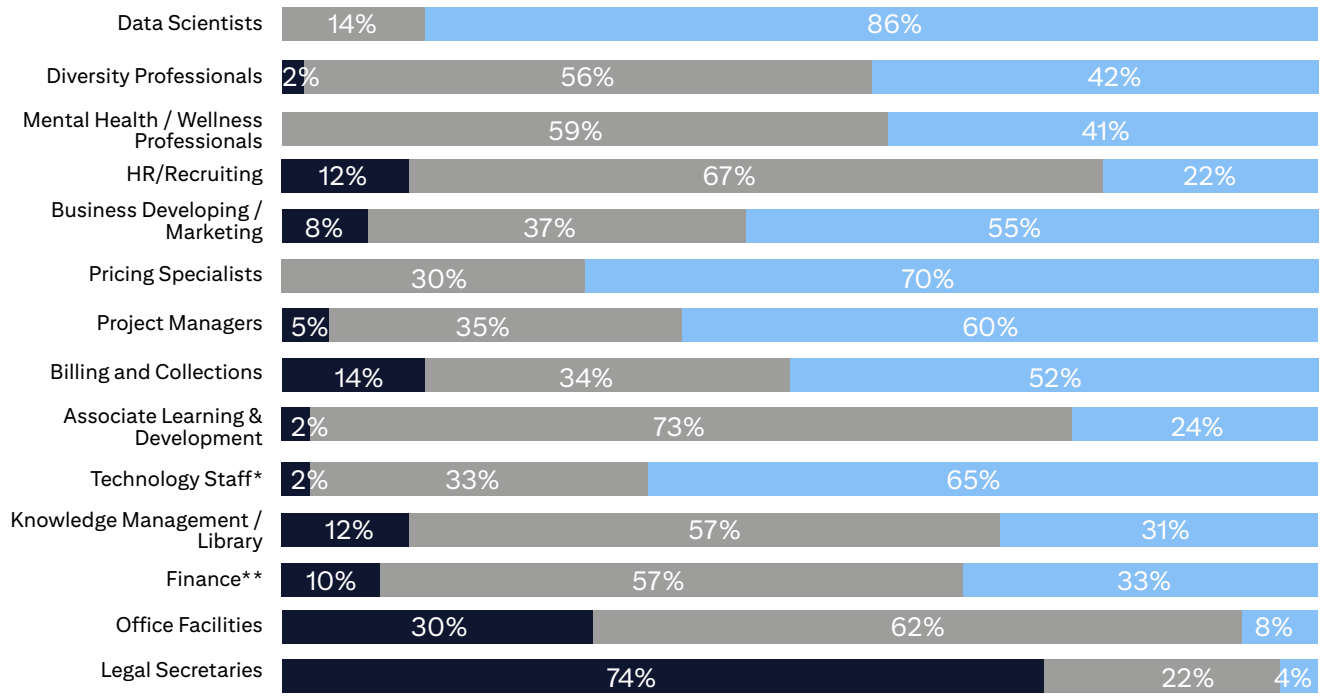
Meanwhile, firms reduced their number of secretaries and office facilities staff. 94% of law firms reduced their secretarial headcount. Office facilities departments also saw significant headcount reductions as businesses responded to the move to flexible work models, with 50% of law firms decreasing the size of these departments.

All of this activity during 2017-22 marks a very clear increase in highly skilled roles within firms and, as such, has led to a more expensive professional staff leverage model. This has been the case even for firms who saw an overall reduction in the size of their professional staff leverage. That being said, these shifts have been critical to the continued success of law firms in a more challenging and competitive market.

Looking ahead, we can expect to see a mix of approaches to the size of professional teams at firms. By 2025, according to the Citi Law Firm Leaders Survey, while 39% of large law firms will decrease their overall professional staff leverage, 48% expect to remain flat, signaling that many believe that they have achieved the optimal size of their professional staff.

We also see this reflected in Figure 11, illustrating likely changes to the composition of the professional staff leverage model over the next two years. As the chart shows, firms believe they have reached the right level for a number of business roles.

Figure 11: Projected Professional Staff Leverage Growth by Category: 2025 vs. 2022



*Excluding data scientists
**Excluding pricing specialists and billing and collections

Source: Citi Law Firm Leaders Survey © Citibank, N.A. July, 2023

The functions where we can expect to see continued investment are in data scientists and technology staff, and in pricing specialists and project managers. The focus on bolstering the data science department and technology staff reflects the anticipated greater use of technology and specifically, the adoption and further use of generative AI as discussed earlier in this report.

And as firms focus on how to deliver legal services more efficiently while growing revenue and profitability, 70% of large firms plan to increase the number of pricing specialists while 60% will add project managers by 2025.

II. More investment in technology

We expect that ongoing investment in technology will remain a key priority for law firms through 2025, with large law firms telling us that their top priority is the further adoption of cloud-based solutions, given growing client acceptance of their use. The second priority is the increasing use of generative AI functionality, as previously highlighted by this report, to become more streamlined and more profitable.

The third priority for firms will be continued investment in information security and cybersecurity, given the ongoing data security risks firms face.

Along with broad infrastructure spending, firms also plan to prioritize their investment in client relationship management systems; and business intelligence and analytics.

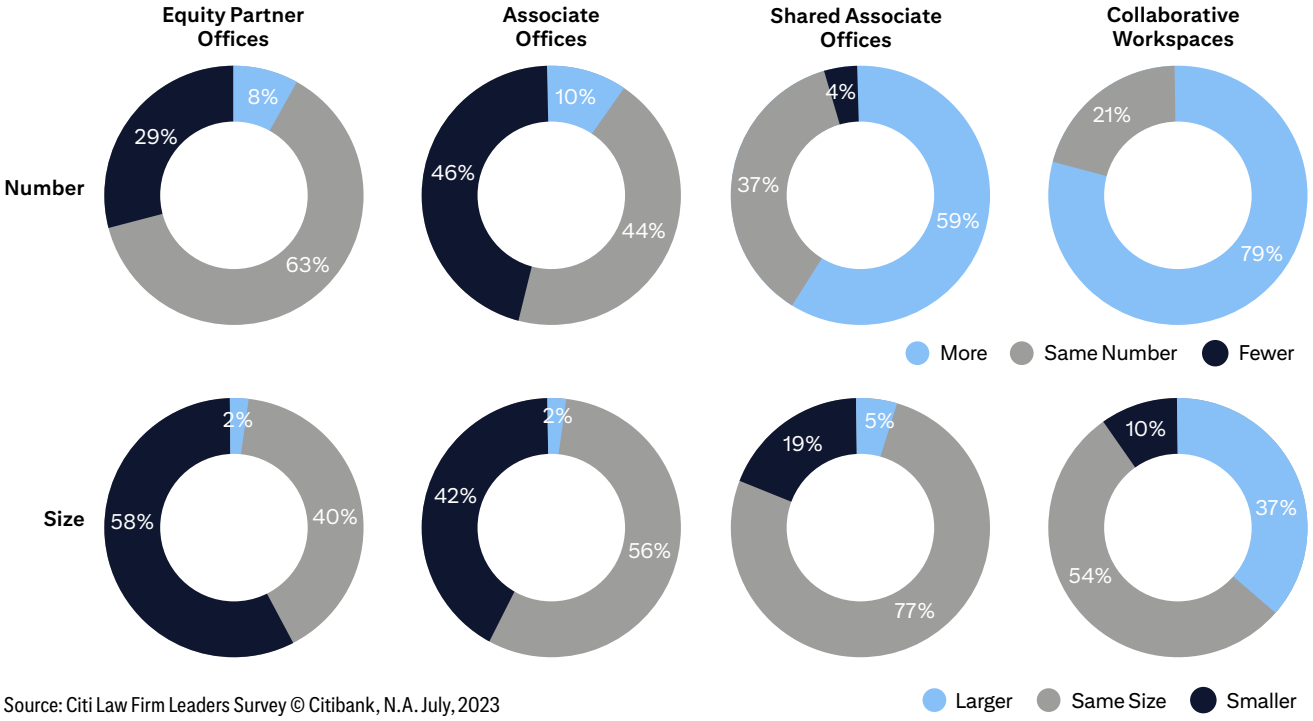
As predicted in last year's report, business analytics is growing in importance for law firms as they seek to further identify opportunities for growth in profitability. Similarly, the focus on client relationship management systems, along with growth in business development professionals, underscores the importance firms are placing on growing revenue and profitability in this highly competitive environment.

III. Rethinking space

We expect to see firms continue to seek efficiencies in their use of space. That said, we see that with another year of a flexible work model under their belts, firms have a greater understanding of new working practices and have revised their approach to their space. In last year's report, we noted that the majority of large firms planned to reduce office space and to use their remaining space more efficiently as their leases came up for renewal. That trend continues this year, albeit less dramatically. In this year's Citi Law Firm Leaders Survey, as illustrated in Figure 12, we saw that more firms plan to keep the same number and size of offices rather than make reductions. In some cases, they expect to increase the number and size of offices compared with last year.

As leases come up for renewal, 58% of large firms plan to reduce their total square footage, down from the 64% of firms who reported a year ago that they expected to reduce their space. Meanwhile, almost a quarter of firms plan to keep their current total square footage, while 19% say they will increase their space – up from the 12% of firms who expected to increase their space when we surveyed them last year.

Figure 12: Associate and Equity Partner Offices: What Will Happen?



Source: Citi Law Firm Leaders Survey © Citibank, N.A. July, 2023

We also see some shift in thinking around the number and size of offices, with more firms than last year projecting that they will stay at their current levels.

63% of firms say they are likely to keep equity partner offices at the same number, up from 57% last year. And, while firms appear to be taking a mix of approaches to associate offices, we see a jump in the proportion of firms likely to stay at current levels compared with last year (now 44%, up from 35%).

Firms are most likely to increase the number of shared associate offices, with 59% saying numbers will increase – similar to last year's projections. Meanwhile, 37% will keep the same number of shared associate offices as they currently have.

Looking at the size of space, the biggest shift in thinking over the past year relates to the size of equity partner offices. 58% of large firms plan to reduce the size of equity partner offices, although this is significantly lower than the 72% of large firms who projected reductions in last year's survey. And, while fewer firms plan to downsize their equity partner offices, 40% plan to keep those offices at their current size (compared with only 28% of firms in last year's survey).

Firms' thinking has not shifted much on associate office size from last year. The majority (56%) will continue to keep their associate offices at their current size, while a notable 42% will see a reduction in their office space.

Shared associate office size will likely stay the same at 77% of firms, up from 70% of firms reporting that to be the case last year.

When it comes to collaborative spaces, 79% of large firms expect to increase the number of such spaces, while 21% will keep the levels the same. More than half (54%) of firms will keep collaborative workspaces the same size, while 37% will increase their size, which is broadly in line with last year's responses. That said, in recent discussions with law firm leaders, we have heard that collaborative spaces are not in high use.

On the use of hoteling, 44% of large firms report its use in some form – still a minority of firms but a jump from the 30% who reported its use last year. Hoteling can mean many different things. While firm projections suggest further growth in hoteling, we also hear from many firms that they believe the concept actually hurts productivity and culture. This suggests that it's unlikely we will see the wide adoption of hoteling in its broadest sense.

IV. Improving pricing and realization

We expect to see firms continue to focus on improving their pricing models and realization levels. Despite all the attention around alternative fee arrangements (AFAs) we continue to see only a small proportion of revenue derived from AFAs.

The Citi Law Firm Leaders Survey found that 20.6% of 2022 revenue came from AFAs, which is the highest average we have seen in the many years we have studied AFA trends.

Similar proportions are projected for 2023. Behind the average, 39% of large firms expect between 10% and 20% of revenue to come from AFAs, while 37% of firms expect that proportion to be over 20%.

Looking to 2025, 72% of law firms expect revenue from AFAs to increase, suggesting a continued focus on alternative pricing models. The predicted increase could reflect the rising proliferation of generative AI tools that firms can now leverage to mine and analyze their existing data – forming the basis of accurate pricing strategies and in turn delivering greater value to clients and to the firm.

We also expect that as AI enables the more efficient delivery of legal services, resulting in fewer hours to produce the same high value outcome for clients, law firms and their clients will need to move toward more value-based billing.

V. Shortening the collection cycle

With the continued lengthening of the collection cycle throughout 2022 and 2023 causing a drag on law firm revenue growth, we expect that firms will remain focused on reversing this trend.

Firms can achieve this by addressing some of the causes of the lengthening head on. While it's hard to tackle unbilled time related to deals on hold in a volatile macro environment, we expect firms will continue to look at ways to shorten the accounts receivable collection cycle where clients have received bills and are simply taking longer to pay them.

Where clients delay payment of bills that aren't compliant with their e-billing rules, we have already seen firms bring on billing and collections professionals to help improve compliance – and we expect this trend to continue.

We also see an opportunity for firms to focus again on more efficient time recording and billing, as we saw in 2020. This, together with a greater focus on writing off inventory that isn't collectible, presents an opportunity for firms to improve their collection cycle and boost revenue and profit growth.

VI. Managing expenses more carefully
Given the inflationary pressures experienced over the past two years, firms have had to absorb large operating expense increases. While expense management may not be as impactful to firm profitability as improving revenue growth, we expect firms to place continued scrutiny on expenses, particularly relating to staff and space.

VII. Increasing cross-selling
In a period of strong growth across both practices and locations, firms have also invested heavily in business development teams to help bear the fruits of that growth, as noted earlier in this report. Looking ahead, as firms plan continued growth, we expect they will focus even more heavily on their cross-selling efforts, across practices and offices – with the goal of increasing wallet share from both existing and new clients.

VIII. Enhancing matter and client profitability
The growing use of business analytics to better understand matter and client profitability will help firms make more informed decisions on which practices to focus on going forward, how to staff matters, and how to price services. We expect firms to deploy a combination of project managers, pricing specialists and new technologies such as generative AI in their pursuit of this.

IX. Focusing more on project management
We expect that firms will continue to focus on project management to deliver legal services more efficiently. We believe that the greater use of generative AI will make project management even more of an imperative for firms than we have seen before. As generative AI likely causes a significant shift in how legal work is produced and priced, we believe that good project management will become an even more important driver of improving profitability.

X. Renewed investment in knowledge management
With the rapid developments in generative AI, we expect firms to continue their investment in knowledge management. While knowledge management efforts have been important for a long time, we have seen a renewed focus on this post-pandemic. We also believe that knowledge management teams are well positioned to play an integral role in the implementation of generative AI at firms.

5. Financing growth

Looking to future financing, some large law firms risk facing a mismatch in capital. In the past, we have seen a reliance on partner capital rather than institutional borrowing to finance future growth. The challenge lies in the increasing number of partners retiring from law firms – who will be entitled to have their capital returned.

This may leave firms vulnerable to an imbalance in capital inflows and outflows, which could compromise future growth.

To help counter this, firms should examine not just capital levels but also the alignment of capital inflows and outflows, and ensure they are able to continue to finance future growth. Citi research shows that for many of the large firms who are projecting growth in laterals, it appears that the capital contributions accompanying these hires will offset a possible capital shortfall for those firms.

6. Financial wellness

Amid the challenge of retaining good people and with growing awareness of the importance and value of lawyer and staff holistic wellbeing, we also expect to see law firms increase their focus on the financial wellness of their teams moving forward.

We see a growing recognition among the highest-performing law firms that if they support the financial wellness of their lawyers and staff – building their awareness through education and training and providing customized planning that is tailored to individuals' needs – those people will be more engaged, more productive and more likely to stay with their firm for a sustained period of time.

As such, we expect more firms to recognize this value and increase their own activity – particularly as broader employee wellbeing continues to grow in the public psyche.

Conclusion

We have written our report at a time of much macroeconomic and geopolitical uncertainty around the world. Despite these challenges, we continue to observe a stable legal profession that has managed to perform better than expected over the years, even in the toughest of times. We credit much of that success to the high caliber of leadership we see in our daily interactions with our law firm clients.

Looking ahead, we expect firms will continue to look for growth opportunities in practices and geographies that further enhance their brands, to attract new talent and clients and to capture more wallet share from existing clients. Most of that growth is likely to come from New York, California, Texas, Washington DC and London, and particularly from technology, healthcare and life sciences, energy, private equity and funds/investment management clients.

While most law firm growth will likely come from promotions and laterals, we may see some mergers and acquisitions involving smaller firms. And among large firms, we may see more UK-headquartered law firms looking to expand their footprint in the US beyond acquiring individuals or small lateral groups.

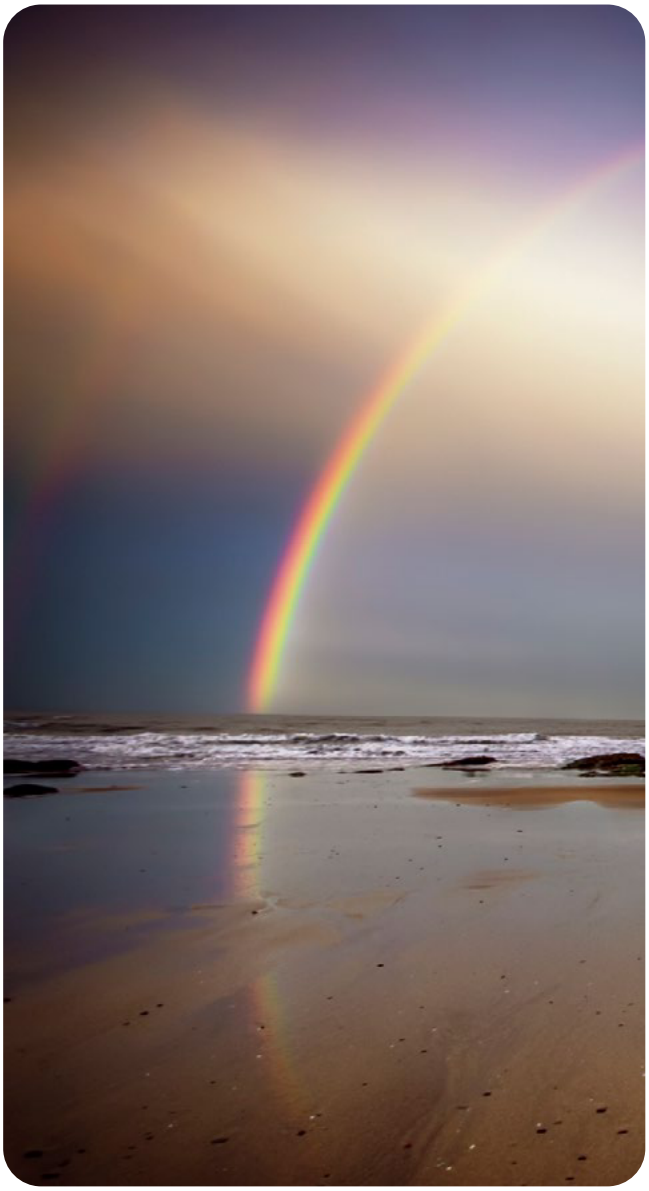
Of course, there remain challenges. While the law firm industry has now seemingly moved on from the discussion around flexible working, talent challenges continue, as firms seek to develop the best lawyers and maintain strong cohesive cultures that bind lawyers to their firms. This will be most evident as firms continue to face the challenge of retaining and attracting top partner talent, in a market where the competition for lateral partner talent shows no signs of easing.

Alongside these talent-related challenges, there is the question of how soon and how much generative AI will affect the practice and business of law. In particular, we anticipate seeing its impact on both lawyer leverage and professional staff leverage. While we may not see much change in the next two years, we expect to see significant change sometime within the next decade. However, rather than viewing generative AI as a threat to the legal profession, we believe that it will create more efficient delivery of legal services to clients and a more rewarding work experience for lawyers.

Aside from the anticipated future impact of generative AI, there are other factors that will drive the focus on operational efficiencies. The expense pressures absorbed by law firms in recent years, together with the revenue-related pressures of soft demand and longer collection cycles, will also drive firms to continue focusing on both expense- and revenue-related operational efficiencies.

It's likely that most firms will see growth in revenue and profitability in 2023, outperforming 2022. Looking forward, we expect continued strength in litigation and regulatory/investigations, bankruptcy and restructuring and the other strong performing practices of 2023. And we anticipate a rebound in transactional practices once interest rates stabilize and market volatility settles. As such, we expect 2024 to be a better year than we saw in 2023.

Credits



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