Understanding the Current Legal Economy

The Current Economic Crisis and Its Likely Impact on the Business and Structures of Law Firms

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James W. Jones

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Overview of Presentation

- **Update on 2008: A Year of Serious Challenges**
  - Current crisis – summary
  - Current crisis – by the numbers
  - Current crisis – likely duration
- **2009: A Look Ahead**
  - Assumptions
  - Projections
  - January/February results
- **A Broader Perspective**
  - Distinctive quality of current downturn
  - Shifting law firm priorities and emerging new models

Update on 2008:
A Year of Serious Challenges

The Current Crisis

- **In legal market, the current economic crisis has exacerbated a slowdown in business evident for several months.**
  - In most firms, productivity dropped in second half of 2007.
  - Driven by slumps in real estate, structured finance, and transactional practices.
  - Resulted in an abrupt end to a six-year period of unprecedented revenue and profit growth.
- **Downturn in 2007 hit regional firms harder than major capital markets firms – driven primarily by reversals in the real estate market.**

The Current Crisis, cont.

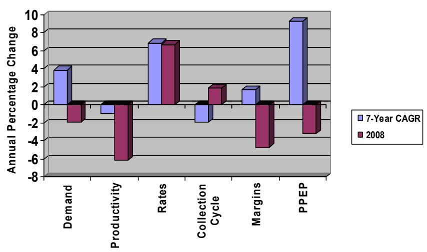
- **In first half of 2008, the impact reversed with regional firms regaining their footing and major capital markets firms bring hit the hardest.**
  - By June 2008, capital markets firms off 10-15% in profits.
  - Firms with large international practices fared reasonably well.
  - Many mid-market firms experienced far less trauma, with some doing reasonably well.
- **All of that changed with the credit meltdown in September and October.**

The Current Crisis, cont.

- **As it became clear that the economic crisis would be deeper and longer than expected, Q4 2008 saw sharp declines for firms across the market.**
  - All firms were hit – global, international, national, and regional.
    - Demand growth for the Citi Law Watch firms fell by a **-7.9%** in Q4 (compared to a positive growth of 0.1% for the first three quarters).
    - Among Peer Monitor firms, productivity dropped **10.4%** in Q4 alone.
  - Even global firms lost their comparative advantage as economic crisis spread around the world.

The Current Crisis – Demand Driven

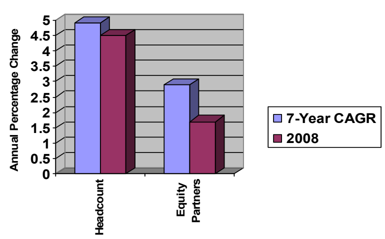
Key Economic Indicators 2008 vs. 7-Year CAGR



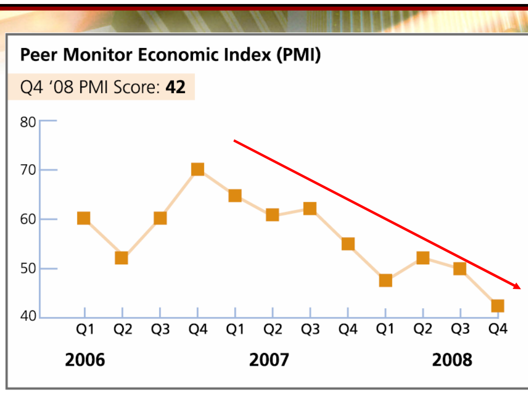
Source: Citi Private Bank *Law Watch*

The Current Crisis – Aggravated by Headcount

Key Personnel Indicators 2008 vs. 7-Year CAGR

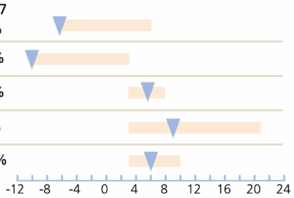


Source: Citi Private Bank *Law Watch*



PMI Key Factors

	Q4 '08	Q4 '07
Demand	-6.6%	2.7%
Productivity	-10.4%	-4.5%
Rates	5.8%	7.6%
Direct Expenses	9%	18%
Overhead Expenses	6%	10.9%



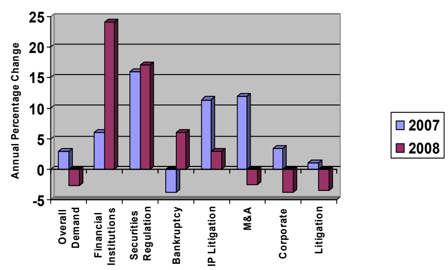
Current Rate (Q4 '08)

2 year range

Change from last quarter

Up Flat Down

Demand Growth by Practice – 2008 vs. 2007



Source: Hildebrandt Peer Monitor

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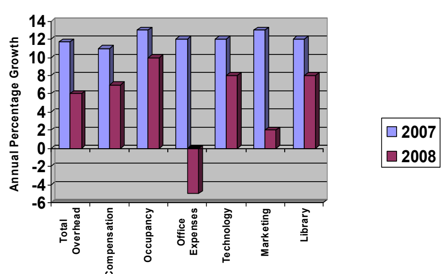
Growth in Overhead Expenses – 2008 vs. 2007



Source: Hildebrandt Peer Monitor

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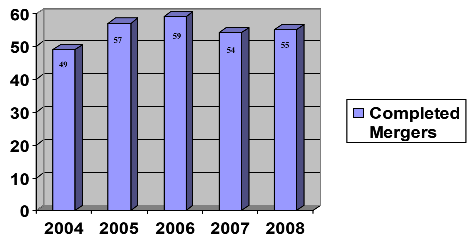
Completed US Law Firm Mergers



Source: Hildebrandt Merger Watch

The Current Crisis – Likely Duration

- **A quick turnaround of this crisis will not be possible.**
  - Credit markets may improve, but it will take a number of months to work through the underlying problems.
  - We do not expect to see any significant turnaround until late 2009, at the earliest.
- **There will be an up tick in some practices:**
  - Countercyclical legal work – litigation, bankruptcy, employment law;
  - Regulatory work relating to reform of capital markets; and
  - Work related to infrastructure and stimulus package.

The Current Crisis – Likely Duration, cont.

- **But such up tick is unlikely to substantially counterbalance the loss of work resulting from the overall economic downturn.**
  - Even if there were improvements in demand in late 2009, it would have little effect on the economic performance of most firms for the calendar/fiscal year.
  - Moreover, the effects of any up tick resulting from counter-cyclical work will not affect all firms equally.

2009:
A Look Ahead

Assumptions for 2009

- **A quick turnaround of the current economic crisis will not be possible.**
- **There will likely be an up tick in some "counter-cyclical" practices –**
  - Bankruptcy and reorganization work
  - Regulatory work relating to capital markets
  - Contract and related work growing out of stimulus efforts
  - Litigation work related to the crisis
- **But these up ticks are unlikely to offset the overall loss of work.**

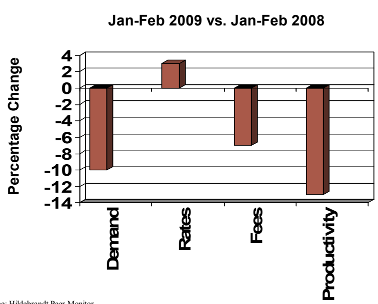
Projections for 2009

- **Flat to declining overall demand**
- **Modest rate increases, heavier discounting, and no uplift from premiums**
- **Modest revenue growth in the 3% range**
- **Additional layoffs and cost cutting (including salary freezes and reductions)**
- **Expenses that (despite these efforts) will rise at a faster rate than revenues**
- **Resulting net income that is flat to down 15% compared to 2008**

Projections for 2009, cont.

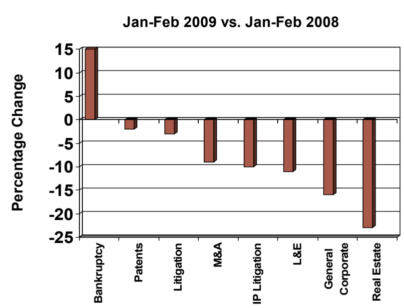
- In part because of dire economic forecast, an increase in law firm merger activity
- Continuation of globalization – with firms positioned to do so continuing to expand around the world
- Higher indebtedness by firms, with higher borrowing costs, more restrictive covenants, and closer scrutiny of capital structures

Key Economic Indicators – YTD Feb 2009



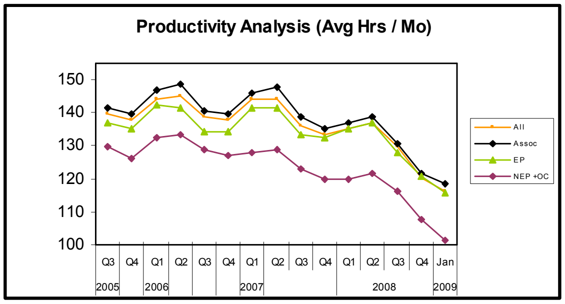
Source: Hildebrandt Peer Monitor

Demand Growth by Practice – YTD Feb 2009



Source: Hildebrandt Peer Monitor

Productivity Challenge



A Broader Perspective

Distinctive Quality of Current Downturn

- **Current recession is significantly different from prior ones and could result in some fundamental changes in the law firm business model.**
  - Shift from a decade of growth and expansion to an extended period of reduced demand and resistance to increases in costs of legal services.
  - Mounting pressure on the one driver of profitability that worked consistently in the 2001-2007 period.
- **Arguably, these changes are a "normal" part of growing competitive pressures in a maturing industry, but the current recession has accelerated their effects.**

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Shifting Firm Priorities

The key challenge for law firms in 2009 and beyond is to “shift gears” from a model premised on growth and expansion to one premised on the more efficient and cost effective delivery of legal services to clients.

Possible Elements for New Models

- **Re-thinking of associate compensation –**
  - To end fixed “starting salary” mentality
  - To increase incentives for performance
  - To move away from locked-step advancement toward competency-based systems
- **Re-thinking of staffing models for the delivery of legal services –**
  - To create new mixes of lawyers (contract lawyers, staff attorneys, counsel, special counsel, etc.)
  - To create management structures to use such combinations efficiently
  - To winnow out underperformers
  - To consider possibility that firms should perhaps have fewer partners and traditional associates

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Possible Elements for New Models, cont.

- **Re-thinking of model for efficient delivery of legal services –**
  - To respond to expanding use of customized, project pricing for major transactions
  - To drive internal versions of “disaggregating” or “unbundling” legal services
  - To drive work to where it can be most effectively and efficiently performed
  - To develop serious project management skills
  - To implement serious business development and leadership training for PGLs and promising younger partners

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Possible Elements for New Models, cont.

- **Re-thinking pricing model for legal services –**
  - To respond to mounting client pressure for "value related" pricing
  - To move away from the "billable hour" as the standard pricing mechanism for all legal services
  - To track and analyze costs in ways that facilitate an intelligent pricing decision
  - To drive greater efficiency and enhanced productivity in the delivery of services

In Conclusion . . .

- **2009 will be a challenging year.**
- **But the recession will end at some point, and when the economy begins to recover, the legal market will lead the way.**
- **Some of the pressures that we are now seeing (especially client resistance to cost increases) will be with us for a long time – forcing firms to reconsider key elements of their business models.**
- **Firms that are able to do so – and really "think outside the box" – could actually emerge from the recession stronger and better positioned to compete than before the crisis began.**

Questions/Discussion