

2016 Australia: State of the Legal Market

The Melbourne Law School and Thomson Reuters Peer Monitor are pleased to present this report setting out the dominant trends impacting the legal market in 2016 and the key issues to influence the market in 2017 and beyond.



Melbourne Law School



the answer company™

THOMSON REUTERS®

FOREWORD



Professor Carolyn Evans DEAN MELBOURNE LAW SCHOOL

It is a pleasure to again welcome this publication of Thomson Reuters Peer Monitor which includes a number of rich data sets of great interest to those in the legal profession and beyond.

The picture that is painted in this report is not a particularly positive one overall, with the headline being slow growth in demand not only in Australia but in many of the major legal markets. Declines in revenue and lawyer numbers make for uncomfortable reading.

The story is varied, however, with some firms continuing to do well in difficult conditions and considerable variation across the pool of firms included in this survey. There were firms that managed a significant increase in revenue even though the general position was one of decline in revenues over the last twelve months. A similar result emerges for demand.

It will come as no surprise to most readers of this report that conditions for the legal sector remain challenging as law firms face difficult decisions about their structure, size, geographic reach and the impact of the digital era on their way of doing business. New entrants are eager to seize a share of the market and disruption is the normal state of affairs.

I hope that readers find this update useful and I congratulate Joel Barolsky for his efforts in collating and presenting this important work.

DEFINITIONS

This report is based on the financial data provided by 21 firms (Australian offices only) and analysis undertaken by Thomson Reuters Peer Monitor®. These firms are categorised as follows:

Big 8 Firms: The largest 8 firms by lawyer count of Australian offices in the analysis, averaging 631 lawyers.

Large Firms: The remaining 13 firms by lawyer count of Australian offices in the analysis, averaging 183 lawyers.

- Figures are representative of the average firm performance in the Peer Monitor program.
- Time periods reflect financial year July to June and the corresponding quarters.
- Key Performance Measures: Defines the rate of change from the stated period to same period 12 months earlier; includes values from all timekeepers (i.e. firm-employed qualified fee earners (Lawyers including Partners), unqualified timekeepers (paralegals, legal secretaries, etc.) and contractors).
 - Demand: Total hours worked
 - Worked Rates: Reflects hourly rate after negotiated discounts from the Standard/Rack Rate
 - Fees Worked: Worked Rates multiplied by Demand
 - Productivity: Hours worked by all timekeepers divided by qualified fee earner FTE (Lawyers including Partners)
- Daily Demand: Total hours worked by all qualified fee earners divided by the number of business days for that month and then measured against the 39-month average; this normalizes demand for months of varying length.
- Productivity: Hours worked by qualified fee earners (Lawyers including Partners) divided by qualified fee earners (Lawyers including Partners).
- Rates & Realisation Progression: Results reflect only qualified fee earners (Lawyers including Partners).
- Expenses: Results reflect a rolling 12 months to annualize heavy expense quarters (i.e. Q4 2016 contains data from July 2015 thru June 2016).
- Market Share: Based on financial YTD GL revenue; includes all fee earners.
- Profit Per Equity Partner (PPEP) is the total profit divided by the number of equity partners (regardless of their point allocation).

For almost the entire 20th century, most law firms got by focusing on just two things: [1] their technical and service *ability*, and [2] maintaining the firm's cultural *stability*, including partner cohesion and retention. Many of these firms flourished despite having undifferentiated brands, poor management disciplines and unsophisticated business models. Super profits were generated by being technically sound and keeping things collegial. More or less, they succeeded by just showing up!

In the past decade, many of the top performing firms have added *affinity* to their core capabilities. By affinity, we mean their focus and investment on building trusted client relationships. With a shift of power to clients, firms have realised that being truly client-centric is critical to getting ahead of competitors and growing their share of client legal spend.

In the years ahead, law firms need to add yet another string to their bow. Sustained success will require a combination of ability, stability, affinity and *agility*. To us, agility refers to:

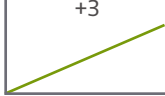



1. Sensing – picking up relevant changes in the client and competitor arenas
2. Nous – identifying creative options and making good commercial choices
3. Adaptation – effective execution of agreed changes to meet new needs and realise new opportunities

The message around agility is not new. The problem is that many practitioners hear this message, but implicitly reject it. In their minds, the call to be agile potentially contradicts two of the foundations of firm success, namely, ability and stability. Typical questions or objections include: how can we innovate and be stable at the same time; how do we self-disrupt and retain our cohesion; how can we proclaim expertise in things we've never done before; why should we risk the very things that have enabled our success to date?

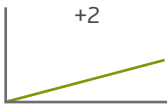
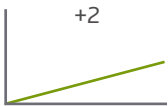
Agility is the ability to be nimble and act gracefully with quick movement. As this report highlights, the ground is shifting under the feet of law firms. Those firms caught flat-footed, unable to exercise the agility needed to respond to a shifting landscape, will find ever-increasing threats to the stability they have counted on for so many years.

Trend Report

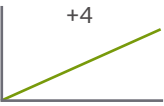
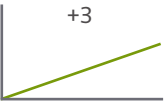
To begin to examine the shifting marketplace, it is helpful to start with an analysis of some of the significant macro trends impacting the Australian legal market. The table below presents the author's analysis of these trends, the trajectory of the Pace of Change trend line and further commentary and evidence supporting the analysis.

Macro Trend	Pace of Change*	Comments																																																								
Lateral partner movements		<ul style="list-style-type: none"> It is widely acknowledged that organic growth in a mature market is hard. Acquiring proven rainmakers from competing firms is the next best alternative to drive revenue growth. While the cultural risks of lateral hiring are well documented, the pace of lateral hiring continued unabated in 2016. It appears that the biggest winners from this trend are the recruiters and business card printers. As legal search expert James Pfahl of Austin Hanley noted, "A few years ago, most of the lateral movement involved individual partners. More recently we've seen whole teams willing to jump ship, including partners, associates and support staff. The degree of change for the acquiring firm and the losing firm can be quite significant. These are much bigger plays with much bigger risks and returns." 																																																								
Entry of global firms into the Australian market		<ul style="list-style-type: none"> While the period 2011 to 2014 saw a flood of new international arrivals, there have been reports of only two cases in 2015/16: Gadens potentially joining up with Dentons Dacheng, and White & Case cherry-picking 14 partners from Tier 1 firms to focus on projects and infrastructure as well as high-level finance. There is little doubt that Australia is a less attractive location for international firms given the end of the mining boom, an unfavourable exchange rate and a highly competitive mature local market. Skadden, Arps, Slate, Meagher & Flom LLP announced in February 2016 that it was closing its Sydney office that it had operated since 1989. The firm employed five lawyers who practiced US law. It is interesting to note, that to date none of the large Asian regional firms have attempted entry into Australia. 																																																								
Shift of work in-house		<ul style="list-style-type: none"> While the number of commercial lawyers working in-house is estimated to have grown from 10% of all practicing commercial lawyers to 35% over the past 15 years, the pace of change has slowed somewhat. Recent presentations by several senior General Counsel indicate that they're under pressure to "do more with less" and contain headcount. Many in-house teams are turning to process redesign, legal project management and use of technology to improve in-house legal team productivity. 																																																								
Convergence (mega firms getting smaller; some mid-tiers getting bigger)		<ul style="list-style-type: none"> Australian Financial Review data suggests the following changes in partner numbers in the period July 2013 to July 2016: <table border="1" data-bbox="542 1381 1000 1591"> <thead> <tr> <th>Firm</th> <th>July 13</th> <th>July 16</th> <th>Change</th> </tr> </thead> <tbody> <tr> <td>Ashurst</td> <td>186</td> <td>142</td> <td>-44</td> </tr> <tr> <td>Clayton Utz</td> <td>197</td> <td>173</td> <td>-24</td> </tr> <tr> <td>Allens</td> <td>163</td> <td>140</td> <td>-23</td> </tr> <tr> <td>DLA Piper</td> <td>104</td> <td>81</td> <td>-23</td> </tr> <tr> <td>Norton Rose Fulbright</td> <td>145</td> <td>123</td> <td>-22</td> </tr> <tr> <td>King & Wood Mallesons</td> <td>154</td> <td>140</td> <td>-14</td> </tr> </tbody> </table> <table border="1" data-bbox="542 1608 1000 1818"> <thead> <tr> <th>Firm</th> <th>July 13</th> <th>July 16</th> <th>Change</th> </tr> </thead> <tbody> <tr> <td>HWL Ebsworth</td> <td>154</td> <td>199</td> <td>+45</td> </tr> <tr> <td>Mills Oakley</td> <td>44</td> <td>84</td> <td>+40</td> </tr> <tr> <td>Hall & Wilcox</td> <td>35</td> <td>64</td> <td>+29</td> </tr> <tr> <td>Thomson Geer</td> <td>63</td> <td>89</td> <td>+26</td> </tr> <tr> <td>Colin Biggers & Paisley</td> <td>43</td> <td>68</td> <td>+25</td> </tr> <tr> <td>Moray & Agnew</td> <td>69</td> <td>87</td> <td>+18</td> </tr> </tbody> </table> <ul style="list-style-type: none"> Interestingly, the market's leading aggregator, HWL Ebsworth, had almost zero net growth for the 2016 financial year. The demarcation of law firms based on size will become increasingly irrelevant. Aligned to this trend is the fact that almost all larger mid-tier firms now have offices in three or more locations. 	Firm	July 13	July 16	Change	Ashurst	186	142	-44	Clayton Utz	197	173	-24	Allens	163	140	-23	DLA Piper	104	81	-23	Norton Rose Fulbright	145	123	-22	King & Wood Mallesons	154	140	-14	Firm	July 13	July 16	Change	HWL Ebsworth	154	199	+45	Mills Oakley	44	84	+40	Hall & Wilcox	35	64	+29	Thomson Geer	63	89	+26	Colin Biggers & Paisley	43	68	+25	Moray & Agnew	69	87	+18
Firm	July 13	July 16	Change																																																							
Ashurst	186	142	-44																																																							
Clayton Utz	197	173	-24																																																							
Allens	163	140	-23																																																							
DLA Piper	104	81	-23																																																							
Norton Rose Fulbright	145	123	-22																																																							
King & Wood Mallesons	154	140	-14																																																							
Firm	July 13	July 16	Change																																																							
HWL Ebsworth	154	199	+45																																																							
Mills Oakley	44	84	+40																																																							
Hall & Wilcox	35	64	+29																																																							
Thomson Geer	63	89	+26																																																							
Colin Biggers & Paisley	43	68	+25																																																							
Moray & Agnew	69	87	+18																																																							

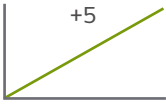
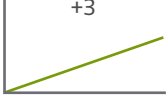

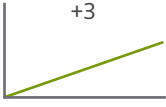
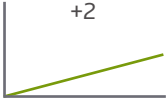
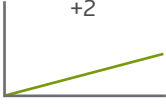
* Pace of Change: on a -5 to +5 scale, where -5 is slowing significantly and +5 is increasing significantly

Macro Trend	Pace of Change*	Comments
Growth of boutique, specialist and focus firms		<ul style="list-style-type: none"> • While there has been significant lateral movement between firms, the trend of law firm start-ups has also continued. The traditional model of boutique firms is to focus on one particular work type, such as employment or corporate M&A. One newer trend is for these firms to concentrate on a particular client industry or sector. An outstanding example of this is Thoroughbred Legal which offers a tailored legal and advisory service to the thoroughbred horse racing industry (www.thoroughbredlegal.com.au). • Another specialist firm of note is Salvos Legal. It is a commercial law firm owned by the Salvation Army where all profits are channeled to the humanitarian efforts of the Salvos. Their target clients include many government, trade union, industry super fund, statutory authorities and other not-for-profit organisations. Salvos Legal also benefits on being able to call on the services of over 60 unpaid legally trained volunteers. • Some specialist firms are expanding their range of advice anchored around one practice. So, for example, family law practitioners are adding corporate law and tax law to their capability sets in order to settle marital disputes amongst high net worth couples.
Growth of NewLaw		<ul style="list-style-type: none"> • Eric Chin, the inventor of the "NewLaw" moniker, stated, "2016 has seen the maturation of some of the established NewLaw players. These companies are now spreading their wings in terms of offerings, business partners, acquisitions and footprint. While the data suggests there are many newcomers, if one scratches the surface, many of these so-called NewLaw firms are very much working off traditional business models. The actual number of genuine new NewLaw firms is relatively small." • Many of the most interesting recent developments in the NewLaw space involve BigLaw firms. It appears these established firms are adopting a hedge strategy and learning new tricks by collaborating with these new entrants: <ul style="list-style-type: none"> - Norton Rose Fulbright and LawPath have joined forces to offer four standard fixed-price services, sold and delivered online. - Gilbert + Tobin has made an equity investment in LegalVision, a Web-based legal document and advisory business. LegalVision facilitated Gilbert + Tobin's highly successful hackathon with the Westpac Bank legal team in February 2016. - DLA Piper has signed an agreement with Lawyers On Demand (LOD) to help develop DLA's freelance/flexible lawyer platform. 2016 also saw LOD's acquisition of Australia's leading company in this space, AdventBalance. - Hive Legal and Neota Logic have formed a partnership to accelerate the adoption of cognitive technologies in the Australian legal market. - Lexvoco, a McInnes Wilson start-up, established an office in New Zealand in June 2016. - Wollongong firm, RMB Lawyers, has set up Australia's first legal process outsourcing business called Unison.

* Pace of Change: on a -5 to +5 scale, where -5 is slowing significantly and +5 is increasing significantly

Macro Trend	Pace of Change*	Comments
Growth of Digital		<ul style="list-style-type: none"> • There is little doubt 2016 is the year of the app. Some of the more interesting software applications launched by Australian law firms include: <ul style="list-style-type: none"> -King & Wood Mallesons' Being a Clerk app to help new recruits make the most of their KWM experience. -Maddocks' ePortfolio platform, a Web-based service that provides property development clients with 24-hour access to project information and virtual contract sign-off and exchange. -Corrs Chambers Westgarth added a Crisis Management app to their growing suite of client apps that includes CASEFOLIO. -Hall & Wilcox's workers compensation insurance app for claims recoveries. -Lander & Rogers' Incident Response app to assist their workplace, health and safety clients. -MinterEllison's Doing Business in Australia app for international clients. -Norton Rose Fulbright's ContractorCheck app that assists with lead generation for those seeking to clarify their employment status. • The discussion around the blockchain and smart contracts and their potential impact on the practice and business of law reached fever pitch during the first part of 2016. The authors' views are that the blockchain will have a profound long-term impact on the market, both positively and negatively. Allens Linklaters sought to create a thought-leadership position in this space by releasing a major report, <i>Blockchain Reaction</i>, in June 2016. • Similarly, significant resources are being invested in artificial intelligence, robot lawyers, predictive coding and expert systems. For most mid-sized and smaller Australian law firms, the aim is to be agile fast followers and adopt proven technologies that add to client and/or firm value. • Herbert Smith Freehills announced a series of co-creation initiatives to improve the client service experience. This included applying human-centred design thinking, lean start-up methodology and elements of agile to prototype and test client innovations. • Interestingly, Gilbert + Tobin released a media statement that it was training its lawyers to code software with US smart contract expert, Taylor Gerring.
Growth of MDPs		<ul style="list-style-type: none"> • PricewaterhouseCoopers (PwC) has publicly proclaimed that they aim to be a top 20 global legal service provider within the next five years. Ex-King & Wood Mallesons Managing Partner, Tony O'Malley, is leading the charge for PwC in Australia. At the 2015 Managing Partners Forum, O'Malley indicated his intent not to replicate the mistakes made by PwC in its foray into legal a decade prior. He said growth would be modest and targeted in key areas that complemented the rest of the PwC offering, particularly international and domestic tax, deals, corporate finance, regulatory and human resource consulting. • KPMG, EY and Deloitte have also flagged interest in growing their legal capability. Each of these firms currently has over 1,000 lawyers working for them, mostly in their tax advisory practices. • It is worthy of note that Deloitte Australia grew its partner ranks by 87 to a total of 664 for the three-year period to 30 June 2016. PwC grew by 83 partners, EY by 126 partners and KPMG by 44 partners.

* Pace of Change: on a -5 to +5 scale, where -5 is slowing significantly and +5 is increasing significantly

Macro Trend	Pace of Change*	Comments
Supply of legal graduates		<ul style="list-style-type: none"> The supply of legal graduates continues unabated despite the fact that most cannot find work in the law. To illustrate this point, there are now 41 law schools in Australia producing over 15,000 graduates per annum. Various reports indicate that students have a 1 in 40 chance of gaining employment in a traditional entry level law firm role.
Focus of talent diversity		<ul style="list-style-type: none"> The 2016 <i>Australian Financial Review</i> partnership survey revealed that women now make up nearly 25 percent of all partners at law firms and a third of partners appointed in the six months to 2 July 2016. This is a significant shift compared to previous years. A report by the Asian Australian Lawyers Association, published in April 2015, found that a “bamboo ceiling” may be preventing lawyers with Asian heritage from rising to senior levels in the profession. The study found that six large law firms in Australia have no partners with Asian backgrounds and that only 0.8 percent of the judiciary have Asian heritage.
Use of off-shore LPOs		<ul style="list-style-type: none"> The demand for low-cost legal process operations (LPOs) in India, the Philippines and South Africa has diminished for a variety of reasons, including the fall in the Australian dollar, labour cost arbitrage and competition from captives and on-shore LPOs. A number of global firms, including Herbert Smith Freehills, Ashurst and Baker & McKenzie, announced expansion of their “nearshore” captive operations providing lower cost discovery, due diligence and document management services.
Growth of legal project management		<ul style="list-style-type: none"> Responding to client demands for better price estimation and resource planning and control, many firms are increasing their investment in legal project management training and tools.
Investment in sales and pricing capability		<ul style="list-style-type: none"> In response to increased competition, many firms are investing heavily in upskilling their partners and senior staff in selling and pricing skills. Some firms have upgraded the sales support technology and are using more sophisticated CRM systems to improve client/prospect selection, pipelines management and account management. The Patrick on Pricing roll call indicates 10 firms with an Australian presence have a pricing director or equivalent role.
Growth in cloud computing and the mobile lawyer		<ul style="list-style-type: none"> Concerns over data security and privacy have put a handbrake on the growth of cloud and mobile computing amongst some commercial law firms. Notwithstanding this trend, intra-firm mobility has seen significant investment. For example, Corrs Chambers Westgarth is currently redesigning all their offices to allow solicitors to work, print and collaborate at any workstation, meeting room or cafe table in the office. 2016 has seen open plan office configurations grow in popularity. While lower per head occupancy costs is the main driver, firms are using office redesign to break down silos, facilitate collaboration and introduce agile-based work methods.

These qualitative trends paint a picture of the shifting market that is only reinforced by an examination of the quantitative data provided by Thomson Reuters Peer Monitor, drawn directly from those firms feeling the impacts of these qualitative shifts.

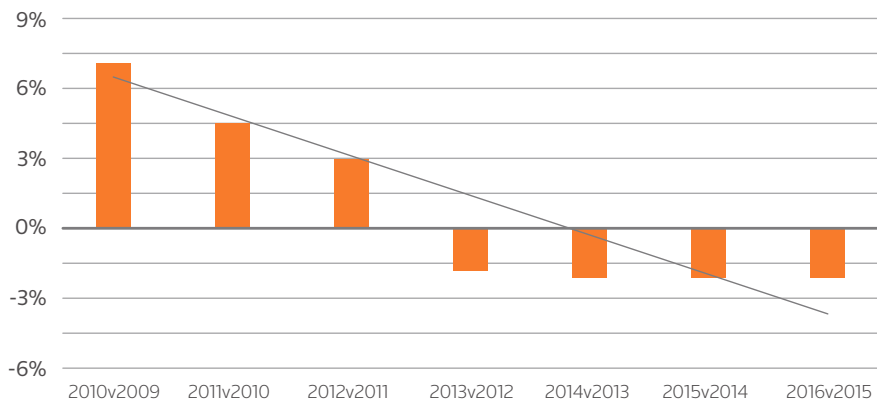
* Pace of Change: on a -5 to +5 scale, where -5 is slowing significantly and +5 is increasing significantly

By the Numbers

Quantitative analysis of the Australian legal market’s performance in FY2016 also reinforces the need for firms to be agile.

The first noticeable trend in the shifting legal landscape is the continuation of a trend seen for most of this decade; a contraction in the average overall demand in law firms. While this is not encouraging, what is, perhaps, a bright spot is that the average decrease in demand from financial year 2015 to 2016 has somewhat stabilised, with a lesser relative decrease in overall demand. On the whole, the average law firm’s demand declined only 1.9% for the financial year. But even with that somewhat encouraging glimmer, the law sector faces increasing financial hardship with only approximately one-third of firms finding revenue and profit growth.

Chart 1: Demand Y/Y Change (2009-2016)



Source: Thomson Reuters Peer Monitor All timekeepers/billable time type/AU offices only

Despite this overall downturn in demand, Big 8 firms fared better than Large firms. In fact, Big 8 firms on average saw demand actually grow for the financial year. Growth was limited to a rather anaemic 0.4%, but compared to the 3.5% contraction in demand experienced by Large law firms, any sign of positive growth should be welcomed.

PRACTICE DEMAND

Examination of individual practices further shows how firms need to be agile when determining which practice areas hold the best potential for the most profit and growth.

For instance, where practice area demand grew for the Big 8, such as in Construction and Dispute Resolution, at 2.5% and 4.6% respectively, Large saw a noticeable contraction at -10.3% for Construction and -9.2% for Dispute Resolution.

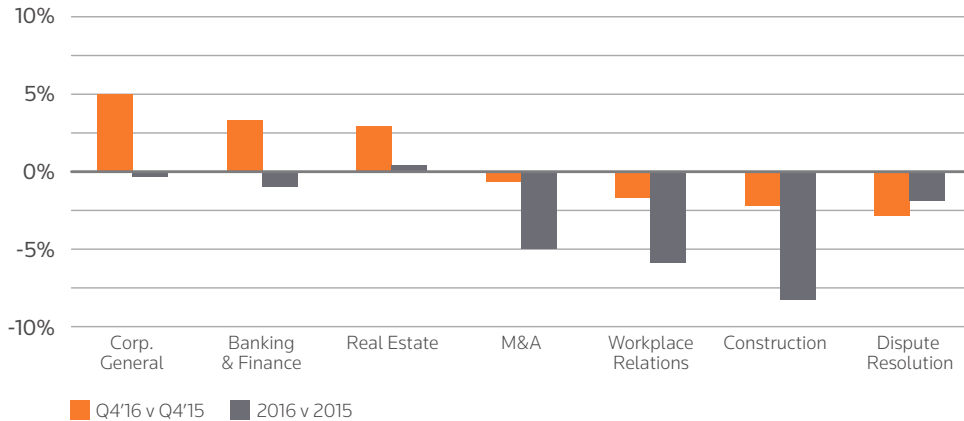
Other core practices were a similarly mixed bag.

Chart 2: Y/Y Demand Growth (2016v2015)



Source: Thomson Reuters Peer Monitor All timekeepers/billable time type/AU offices only

Chart 3: Y/Y Demand Growth



Source: Thomson Reuters Peer Monitor All timekeepers/billable time type/AU offices only

Banking: Demand for the third largest practice area (Banking & Finance) experienced a minor slump, showing a slight decline at -1.3% for the financial year. But in an encouraging sign, firms' Banking & Finance practices averaged 3.2% demand growth in Q4 FY2016.

Corporate: Big 8 firms experienced weaker Corporate demand for the 2016 financial year, declining 1.9%. Conversely, demand for Large gathered momentum, up 1.5% for general corporate law advice.

Transactional Work Growth

M&A: M&A work saw a 5.0% decrease in demand for the financial year.

While the Asia-Pacific region is generally on a growing trajectory for M&A activity, Australia has recorded its lowest market share of overall APAC M&A's, which has been attributed to a "tepid" response from the market as the federal election acted as a dampener on M&A activity. This uncertainty, coupled with a stronger Australian dollar, likely contributed to a reduced number of inbound transactions from foreign bidders. On the whole, M&A was anticipated to be a key growth area for FY2016, but in reality, underperformed.

Real Estate: Real Estate was one of the few growth practices for FY2016, slightly above flat at 0.2%. However, given the significant slump in Construction and property development, which was down 8.4% for the financial year, Real Estate may well face softening demand for FY2017.

The downturn in M&A also appears to have impacted Real Estate demand. Compared to FY2015, which recorded a total transaction value of AU \$13 billion for Real Estate transactions, the financial year ending 2016 reported an 89.9% slump in Real Estate-related M&A deals, falling to a total value of AU\$1.3 billion.¹

Table 1: Practice Demand Growth – All Firms

Practice Area	Proportion of Work	Growth (2016 v 2015)
Taxation	2%	3.2%
Real Estate & Projects	10%	0.2%
Corporate General	13%	-0.3%
Insurance Defence	7%	-0.7%
Banking & Finance	12%	-1.3%
Dispute Resolution	21%	-1.9%
Regulatory	2%	-3.0%
Intellectual Property	3%	-3.5%
M&A	9%	-5.0%
Workplace Relations	6%	-6.0%
Construction	8%	-8.4%
Environment & Planning	2%	-10.1%
Insolvency & Restructuring	3%	-12.0%

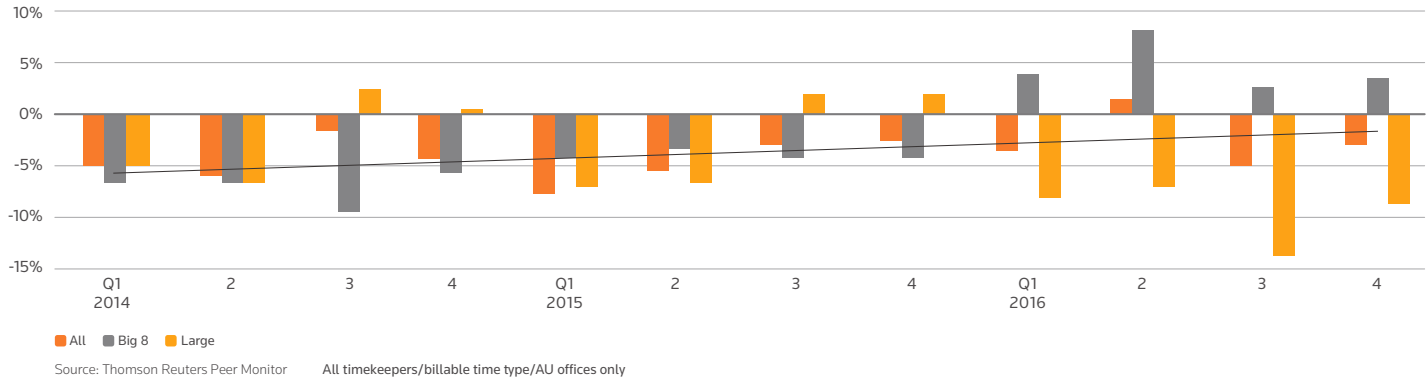
Source: Thomson Reuters Peer Monitor All timekeepers/billable time type /AU offices only

1. <http://www.lawyersweekly.com.au/news/19207-energy-remains-most-active-m-a-sector>

Litigious Work

The decline in the demand for litigation work has continued throughout 2016 for Large firms, with the segment’s average market demand for dispute resolution services declining 9.2% on last year’s figures.

Chart 4: Dispute Resolution Y/Y Growth by Quarter



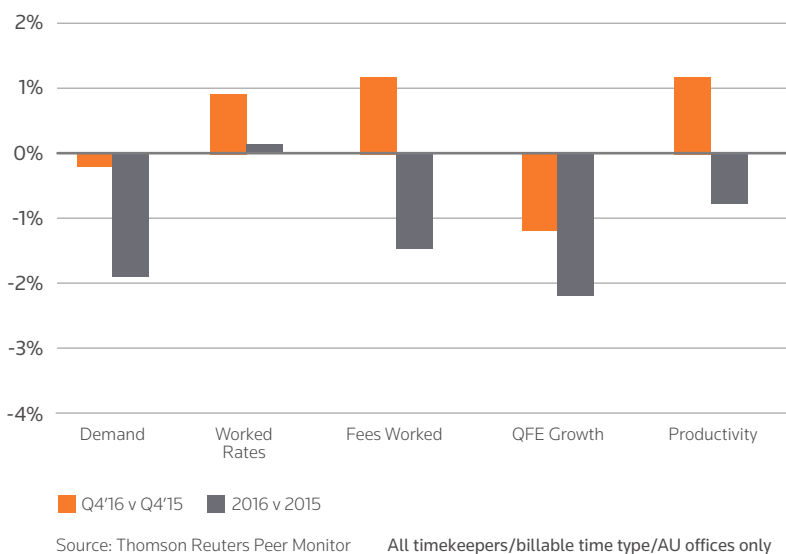
Big 8 firms, on the other hand, defied the expectations of many, posting a surprising 4.6% increase in average demand for Dispute Resolution.

Interestingly enough, disruptive innovations in the form of online Dispute Resolution firms have begun to spring up in places such as Silicon Valley, foreshadowing a potential shift in the way litigious work is conducted in the longterm.² How this will impact a litigious work market that is already experiencing strain will be an interesting trend to watch.

Key Performance Indicators

Australian law firms have, indeed, shown some agility in their strategies for managing qualified fee earners (QFEs). The end of FY2016 saw a decline of 2.2% in the number of QFEs, which reflects a similar 1.9% decrease in overall demand. This suggests that firms have, indeed, been making efforts to adapt their practices and “rightsize” to the market.

Chart 5: Overall Key Performance Indicators

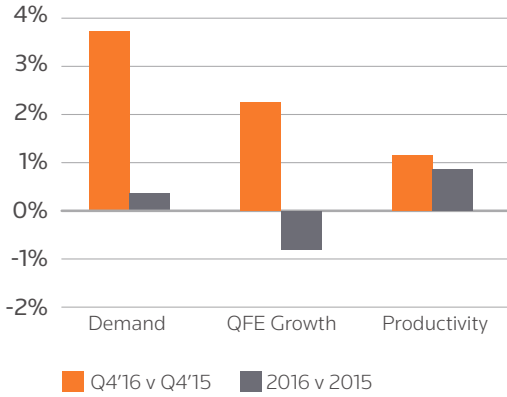


2. <http://www.lawyersweekly.com.au/news/19358-compelling-case-for-online-dispute-resolution>

Despite a shrinking number of heads, declining demand coupled with near stagnant rates led to a year-end contraction in firms' average total Fees Worked by 1.5%. Big 8 firms experienced small positive improvements in their Key Performance Indicators. Those firms not only saw a 0.4% increase in demand for the FY2016 period, but also recorded a 0.9% jump in productivity.

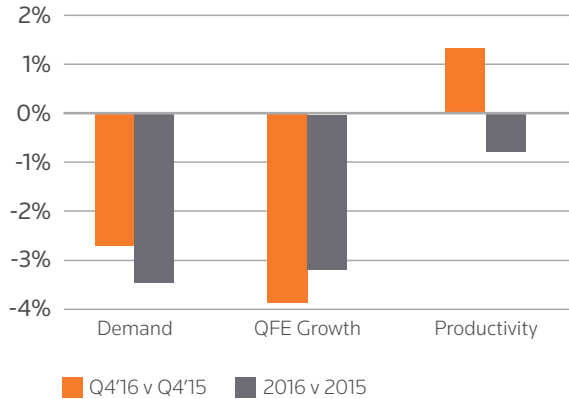
In contrast, Large law firms saw declines across the Key Performance Indicators. One bright spot for Large firms was the positive uptick in Q4 productivity, but even this was not enough to stave off lacklustre year-end results.

Chart 6: Big 8 Key Performance Indicators



Source: Thomson Reuters Peer Monitor
All timekeepers/billable time type/AU offices only

Chart 7: Large Firms Key Performance Indicators

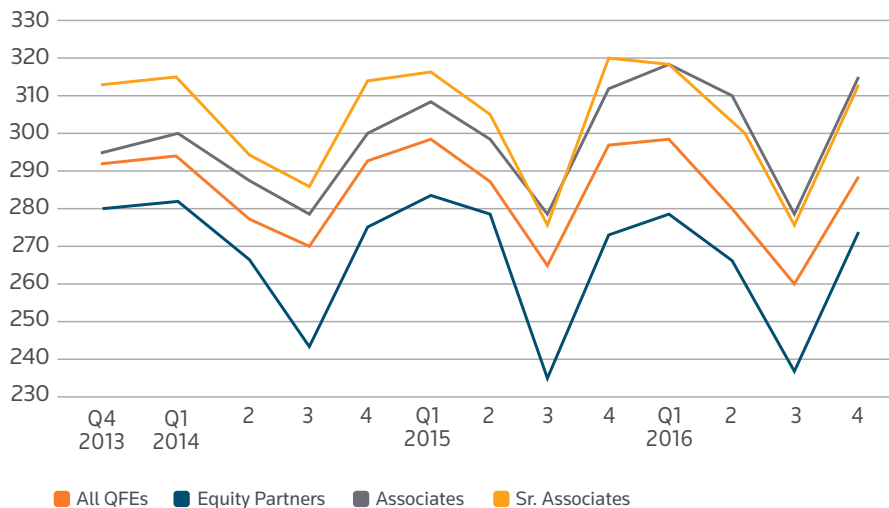


Source: Thomson Reuters Peer Monitor
All timekeepers/billable time type/AU offices only

PRODUCTIVITY

According to Peer Monitor, the average hours per quarter worked by lawyers as a whole in all the surveyed firms over the preceding 13 quarters generally maintained the expected cyclical trend, similar to data from previous years (see Chart 8).

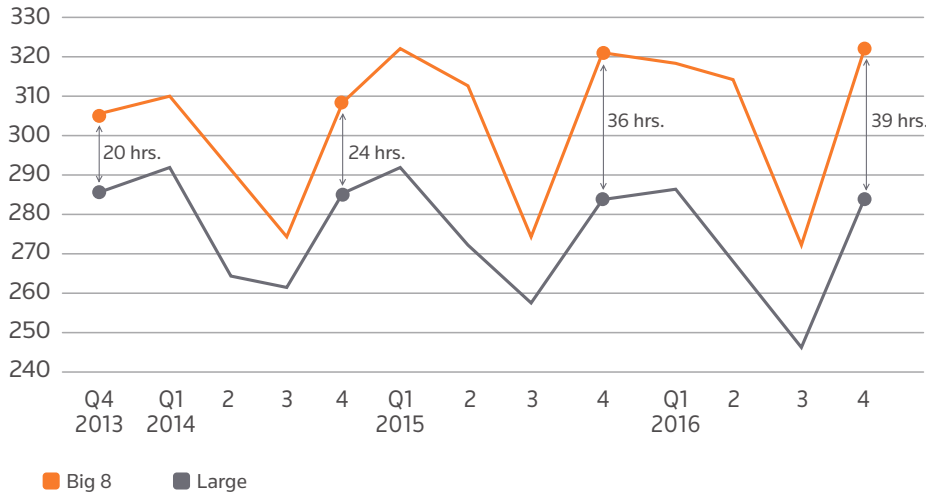
Chart 8: Productivity per Qualified Fee Earner



Source: Thomson Reuters Peer Monitor All qualified fee earners/billable time type/AU offices only

As Chart 9 demonstrates, Big 8 QFE’s work approximately 39 hours per quarter more than their counterparts in Large firms, continuing the trend seen for more than the last three years. The growth in this productivity differential could be ascribed to higher expectations, better recruitment, more aggressive headcount reduction, superior systems and larger average matter size.

Chart 9: Productivity per Qualified Fee Earner by Segment



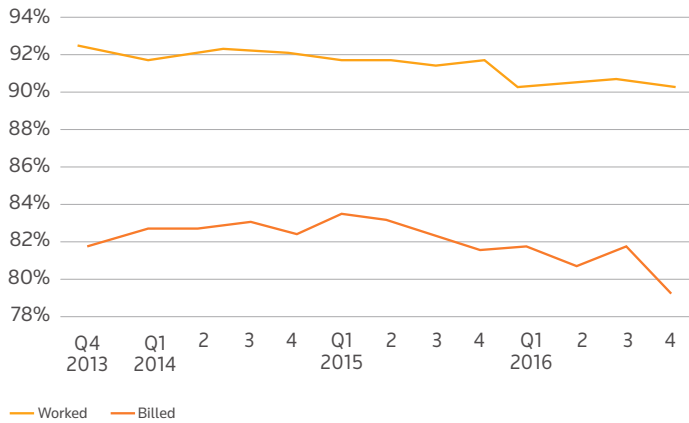
Source: Thomson Reuters Peer Monitor All qualified fee earners/billable time type/AU offices only

In fact, not only is the gap widening, Big 8 and Large firms are actually moving in opposite directions in terms of hours per quarter. While Big 8 has increased from 306 to 322 hours over the last 3 years, Large firms have seen their hours decrease from 286 to 283 hours per quarter.

Rates and Realisation

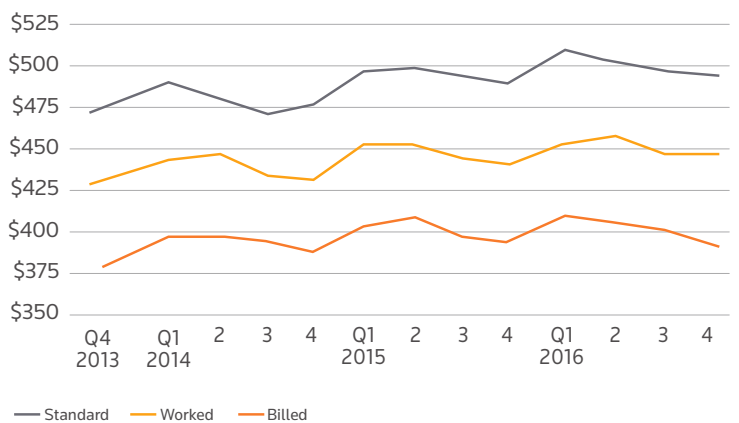
As Chart 11 shows, billing rates for all firms have marginally increased over the past three years, up 3.43%. However, this increase in billing rates correlated with a significant decrease in realisation, dropping to 79% against the standard rate, as firms are more willing to take on business while offering steeper discounts.

Chart 10: Overall Realisation Against Standard



Source: Thomson Reuters Peer Monitor All qualified fee earners/billable time type/AU offices only

Chart 11: Overall Rate Progression



Source: Thomson Reuters Peer Monitor All qualified fee earners/billable time type/AU offices only

We also note that from Q4 2015 to Q4 2016, there was no significant net increase in Billed Rates, demonstrating potentially troubling rate stagnation. In fact, Q4 Billed Rates actually declined as compared to Q1 or Q2 each year since 2013. This may indicate an effort on the part of law firms to reach year-end financial objectives by offering higher discounts to clients.

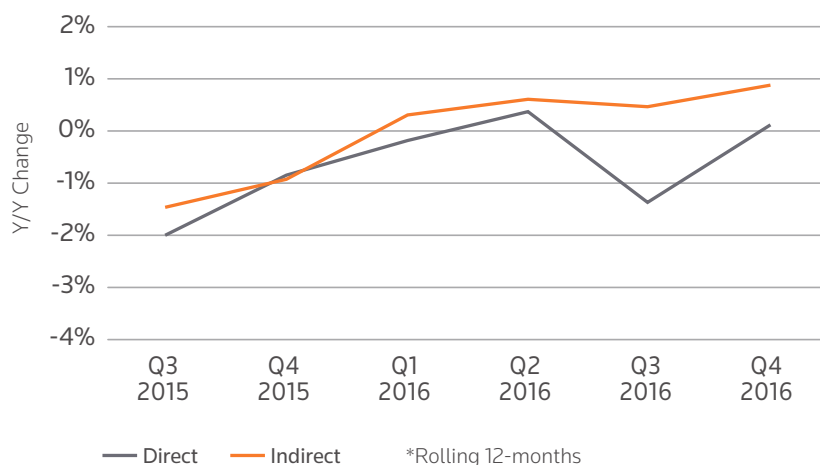
Where rates are stagnant, firms must find different ways to respond to market forces and find profitability, again, highlighting the need for a nimble approach to strategic management.

Expenses

Law firm expenses began to increase slightly through the end of FY2016, with indirect expenses up 0.9% and direct expenses remaining stable with no percentage change on Q4 last year, after having shrunk compared to FY 2015 for most of this financial year.

For the Big 8, indirect expenses grew by 3.1%, while direct expenses grew at a slower 2.4%. While the Big 8 was growing expenditures, Large firms have continued cost-cutting measures, shrinking indirect costs by 0.6% and direct costs by 1.6% respectively. This may be an indication that Big 8 firms have been able to steer these increased expenses into areas of investment that have helped to boost demand.

Chart 12: Overall Expense Growth*



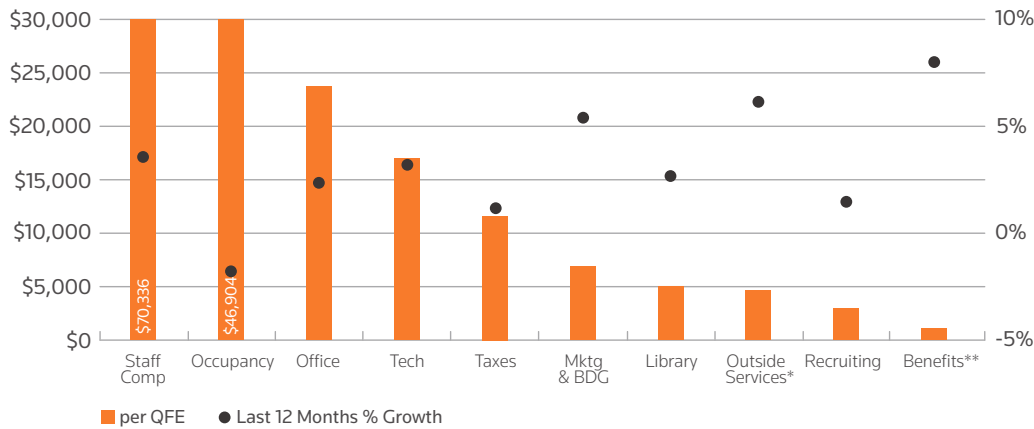
Source: Thomson Reuters Peer Monitor

Compared with 2015, FY2016 overall average spend for Staff Compensation rose 3.6%. Most of the growth in Staff Compensation was driven by the Large firms, increasing compensation by an average 4.8%. Big 8 firms still increased Staff Compensation, but by a more moderate 2.9% average per firm.

Sector wide, Benefits expenses experienced the largest growth, averaging 8.0% growth in FY2016. Big 8 firms actually pulled back their Benefits costs by 15.7%, compared to FY2015. In contrast, the Large firms have allowed Benefits-related costs to grow 11.6% in FY2016, as certain firms are offering greater individual Benefits in the form of family policies such as more extensive paid parental leave.³ It will be interesting to watch how increased spending on Benefits by Large firms will impact retention.

3. <http://www.lawyersweekly.com.au/news/19372-melbourne-office-bolsters-family-friendly-policy>

Chart 13: Overall Indirect Expense Detail



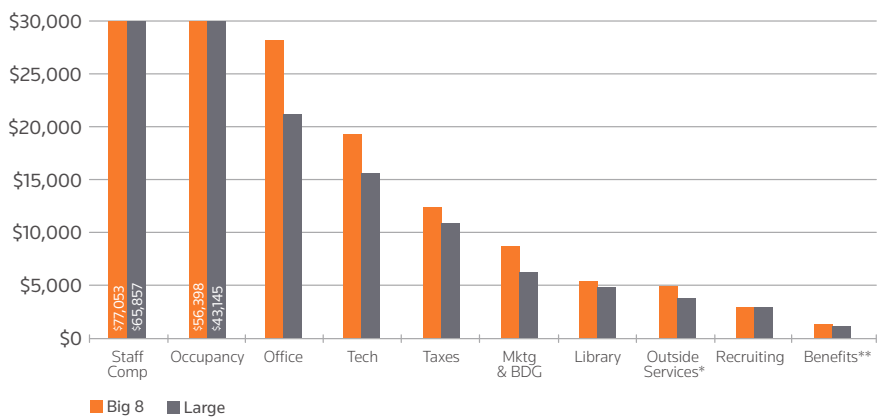
Source: Thomson Reuters Peer Monitor

Highlighting the continuing trend of developing reliance on achieving efficiencies through technology, expenditures on technology increased 3.3% in FY2016. Increased investment in technology may help to explain some of the productivity gains seen by Big 8 firms, although productivity results seen in Large firms may paint a different picture.

Expenditures on Marketing & Business Development increased by 5.4% overall compared to FY2015. However, weak overall demand for legal services highlights that current marketing strategies have not been effective enough on a national scale to lift client demand. It should be noted, though, that Big 8 firms grew their Marketing and Business Development expenditures by a considerable margin, and saw positive demand growth for the year. At the same time, BD expenditures for Large firms actually contracted for the year, correlating with shrinking demand for the segment.

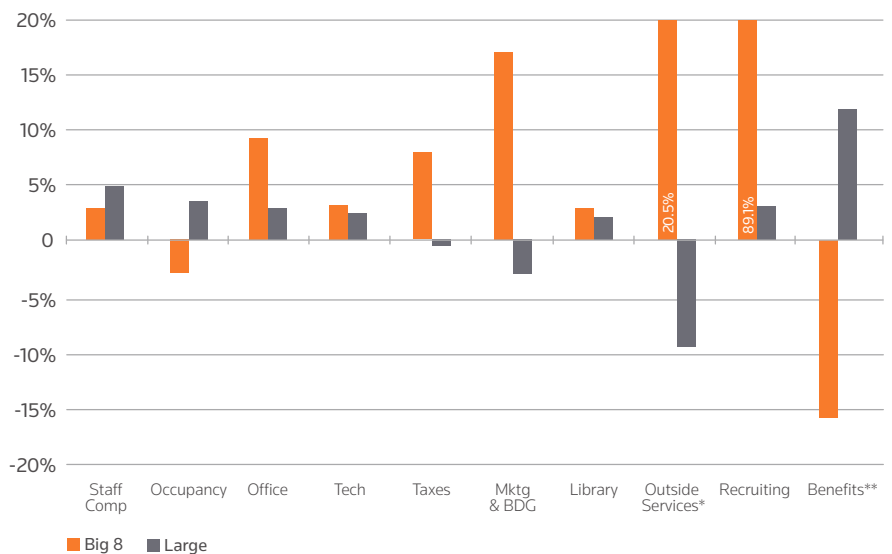
It has often been said that an organisations priorities are reflected in how it invests its money. At least with regard to Big 8 firms, placing a priority on technology and business development seems to have been a successful strategy for this year. These types of expenditures may well reflect just the type of focus on agility that we advocate.

Chart 14: Per Lawyer Expenditure (Rolling 12 Months)



Source: Thomson Reuters Peer Monitor

Chart 15: 2016 v 2015 Per Lawyer Indirect Expense Growth



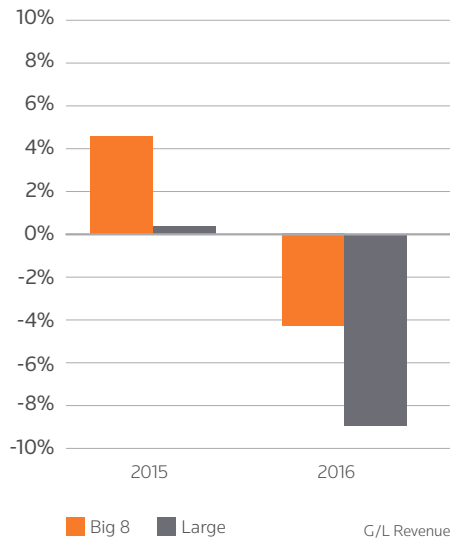
Source: Thomson Reuters Peer Monitor

*This includes outsourced services for mailroom, copy center, and records management, etc. This also includes professional services such as tax return preparation, outside legal services, payroll processing, trust administration expenses, employee benefit consulting and other consulting services. This does not include outsourced technology functions, (e.g., helpdesk and datacenter, see Technology), or outsourced marketing functions, (e.g., public relations and market research, see Marketing). This category does not include temporary help.

**This includes firm-paid employee insurance (medical, dental, and other health and welfare coverage, life/disability/long-term care, accidental death coverage, travel insurance, income protection, etc.), firm-paid retirement benefits (pension plan/profit sharing contributions, retirement plan expenses), and other firm-paid benefits (e.g., employee assistance programs, transportation allowances, overtime transportation, childcare assistance, golf/health club memberships, wellness programs, physical exams, tuition reimbursement for dependents, etc.)

Profitability

Chart 16: Profit Growth



Profitability presented a considerable challenge for the Australian market in FY 2016. As Chart 16 demonstrates, the profitability of the Big 8 firms declined sharply, decreasing 4.4% for the financial year. In comparison, Large firms saw a dramatic decrease of 9.0% in FY2016.

Rising costs, coupled with stagnant rates and declining demand, drove profitability down for most firms. The saving grace for Big 8 firms was the slight uptick in demand for the financial year.

Faced with these challenging conditions and needing to cut costs, many firms looked to thin their partner growth rates as a way to protect profitability. The *Australian Financial Review* Law Partnership Survey highlighted this effort as law firms faced unprecedented competition from accounting firms and independent legal contractors.⁴ For example, Big 8 firm Norton Rose Fulbright lost 22 partners in the past year and only managed to replenish 12 partners, leaving a net loss of 10 for FY2016.

The data indicates that there is an overall trend within the industry in stabilising the number of Equity Partners, while significantly increasing those Of Counsel. In fact, Of Counsel ranks increased by 11.3% in FY2016.

This perhaps reflects a trend to try to shift costs from fixed to variable, and

move senior partners out of equity to consultant roles. At the same time, previous increases in non-equity partners have been completely erased in FY2016, signalling an overall shift in the sector towards reducing the total number of lawyers per firm.

Despite these efforts, both the Big 8 and Large firms experienced significant drops in PPEP of 5% and 10% respectively. For Large firms, this can be attributed to their weaker demand and thus lower revenue, whereas for the Big 8, despite their increase in demand and revenue, their costs continue to increase, subduing any potential gains in PPEP.

Chart 18: Three-Year Growth by Lawyer Title

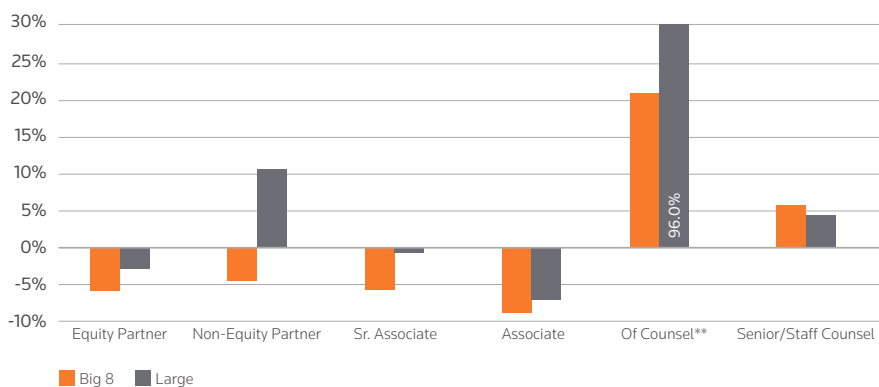
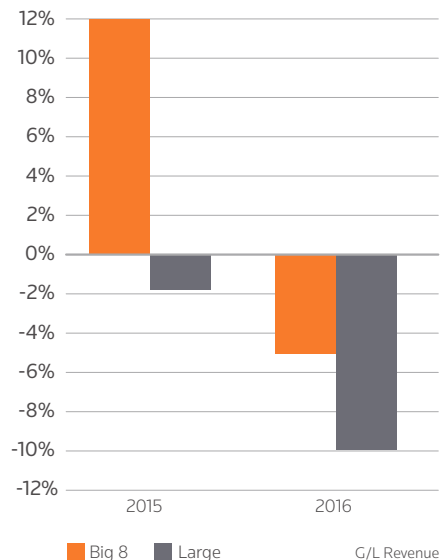


Chart 17: Profit per Equity Partner (PPEP)* Growth



* Profit Per Equity Partner (PPEP) is the total profit divided by the number of equity partners (regardless of their point allocation).

** An Of Counsel timekeeper is a high profile lawyer but is not a Partner. They may have a special relationship with an industry or the government or are hired for another unique reason. Retired and former partners are included in this category. We would expect these fee earners to have a billing rate similar to Partners.

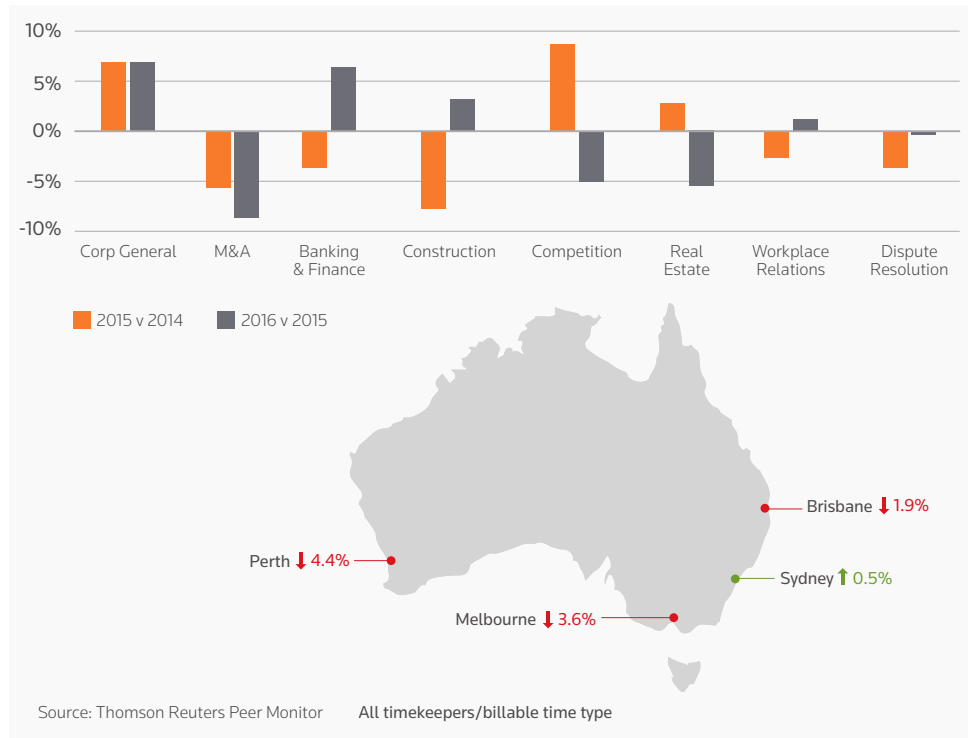
4. <http://www.afr.com/business/legal/law-firms-shrink-partner-numbers-as-clients-cut-back-20160620-gpnvdm>

NO UNIFORMITY NATIONALLY

As depicted in Figure 1, weakening demand overall in Perth, Melbourne and Brisbane coincide with the weakening performances of both the Big 8 and Large firms across Australia.

On the other hand, Sydney bucked this trend by showing an average increase in demand for legal services, driven by strong Corporate (up 7.1% in FY2016) and Banking & Finance (6.9% demand increase) sectors in Sydney as compared to other cities.

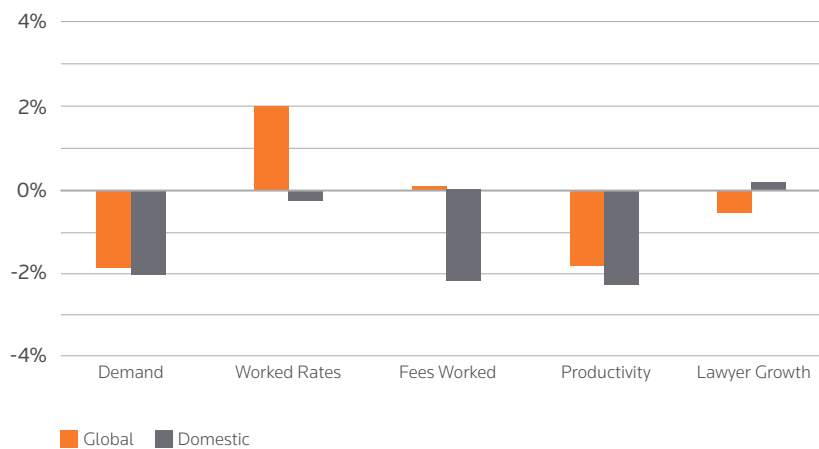
Figure 1: Practice Demand – Sydney



Local vs. Global

Domestic Australian firms are on no more stable a footing when compared to their Global counterparts.

Chart 19: Key Performance Measures 2016 v 2015



The Peer Monitor data was recut by grouping firms into two categories:

Global and Domestic. The Global firms are six firms with a large global footprint. Domestic are the remaining 15 firms.

Demand growth in Australia for the Global firms was down an average of -1.9% for the financial year, while Domestic firms suffered a similar decline of -2.0%. According to the *Ibis Report*⁵, this discrepancy in demand growth could be attributable to small and medium size domestic businesses being deterred by “fluctuating consumer confidence” and increasing demand for better value for money. In any case, the Global firms are not immune to the domestic market conditions in Australia.

To call out a specific example, Global firm Ashurst recorded a significant decrease in revenue of 10% as compared to the FY2015.⁶ Similarly, its PPEP growth has undergone a downward spiral, falling 15.7% to a 11-year low in FY2016.

Practice demand was a mixed bag for both Global and Domestic firms as well. For Global firms, only Corporate and Banking & Finance showed positive growth for the financial year. In contrast, Domestic firms were more likely to experience growth in Real Estate. And interestingly, any area where a Global firm saw growth, Domestic firms saw contraction, and vice versa. Either one segment of firms lost in a given practice, or they both did.

Chart 20: Domestic vs. Global by Practice 2016 v 2015



Source: Thomson Reuters Peer Monitor All timekeepers/billable time type/AU offices only

5. <http://www.ibisworld.com.au/industry/default.aspx?indid=560>

6. <http://www.legalweek.com/sites/legalweek/2016/07/07/ashurst-pep-plunges-19-as-revenue-falls-10-in-2015-16/>

In Conclusion

The Peer Monitor quantitative data plus the author's qualitative analysis point to a legal market in a state of considerable flux. If anything, the pace of change is increasing. The more progressive firms have woken up to the reality that if you're not changing faster than your competitive environment, you're going backwards. These agile firms are pulling ahead from the rest of the pack and will continue to outperform.

With the growth of multidisciplinary practices, digital solutions and NewLaw models, the available share of total legal spend going to traditional law firm partnerships is contracting. This contraction may be in the order of 40% by 2021. The rules of the game in this market are changing and the window of opportunity to embrace a fresh approach is closing.

The key leadership challenge is to discern what to conserve and what to let go. Firms need to have honest and intensive conversations around the things to protect, and the areas of change. The inherent contradictions and paradoxes of ability, stability, affinity and agility need to be explored and worked through. At the same time, leaders need to be resolute that it's an AND argument not an OR argument – the firm needs all four elements, not just one or another. Without this level of introspection, innovation will just be a fad and will never become a core strategic capability. Without some innovation, just being able and collegiate will not be enough.



Melbourne Law School (MLS) is one of the professional graduate schools of the University of Melbourne. Located in Carlton, Victoria, MLS is Australia's oldest law school to begin teaching operations, and offers J.D., LL.M., M.Phil., Ph.D., and LL.D. degrees. MLS is the only Australian member of the Law School Admission Council; and, in 2014-2016, it was ranked as the best law school in Australia and eighth best in the world by QS World University Rankings. In 2013, it was ranked the fifth best law school in the world. For more information, go to law.unimelb.edu.au/.



Barolsky Advisors is a leading management consulting firm with a deep understanding of the culture and complexities of professional service organisations, in particular, law, accounting, engineering and business advisory firms. The firm specializes in strategy formulation and implementation. The founder, Joel Barolsky, is a Senior Fellow of the Melbourne Law School and formerly a Principal of Beaton Research + Consulting. For more information, go to barolskyadvisors.com/.

PEER MONITOR[®]

Peer Monitor is a dynamic, live benchmarking program that provides anytime access to critical firm assessment information and allows comparison against selected peers, with details for practice performance. It covers key metrics such as demand, rates, productivity and expenses broken out by practice groups, offices and individual timekeepers, enabling easy views to managing partners, practice group leaders, and other law firm leaders at summary and detailed levels. Peer Monitor is a product of Thomson Reuters, the world's leading source of intelligent information for businesses and professionals. For more information, go to peermonitor.thomsonreuters.com.