2017 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 2017 and the key issues to influence the market in 2018 and beyond.

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FOREWORD

Professor Jenny Morgan
DEAN, MELBOURNE LAW SCHOOL

I am pleased to welcome the 2017 edition of the State of the Legal Market report.

It would have escaped the attention of few readers that the Australian legal profession faces ever-growing challenges related to the impact of technology. These challenges bear upon both the delivery of legal services and the operation of the law firms themselves.

The pace of change is relentless, and firms face pressure to respond to the demands of clients to access legal services in new and innovative ways. Added to this is the pressure from the judicial and regulatory system, whose bodies have now been facilitating paperless document management for several years in many instances. Pressure also comes from within, as employees' working preferences evolve to embrace new technologies.

As with most challenges, significant opportunities are there for the taking for those firms with the requisite combination of leadership, resources, and agility. Technology tantalisingly offers the ability to do more, or even better, with less. From the use of basic collaborative drafting tools to complex analytics and big data, there are few aspects of legal practice lacking the potential to be affected by technology.

How firms choose to respond to technological challenges represents, as the author discusses in his conclusion, a major strategic decision. I have no doubt that this paper will provide valuable guidance for many in the profession as they evaluate what the coming year may hold, and I commend Joel Barolsky for his work in preparing this report.

The Melbourne Law School and Thomson Reuters gratefully acknowledge the participation of the following persons in the preparation of this report: Joel Barolsky, Senior Fellow & Principal at Barolsky Advisers (lead author); Joe Blackwood, Analyst, Client Management & Thought Leadership at Thomson Reuters; Justin Hines, Analyst, Client Management & Thought Leadership at Thomson Reuters; Bill Josten, Sr. Analyst, Client Management & Thought Leadership at Thomson Reuters.

DEFINITIONS

This report is based on the financial data provided by 18 firms (Australian offices only) and analysis undertaken by Thomson Reuters Peer Monitor. These firms are categorised as follows:

Big 8 Firms: The largest eight firms by lawyer count of Australian offices in the analysis, averaging 625 lawyers.

Large Firms: The remaining 10 firms by lawyer count of Australian offices in the analysis, averaging 214 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
- Billable time type: Non-contingent matters
- Key Performance Indicators: 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], 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
  - Utilisation: Hours worked by all fee earners divided by qualified fee earner FTE (lawyers only)
- Utilisation: Hours worked by qualified fee earners (lawyers) divided by qualified fee earners (lawyers)
- Rates & Realisation Progression: Results reflect only qualified fee earners (lawyers)
- Expenses: Results reflect a rolling 12 months to annualise heavy expense quarters (i.e., Q4 2017 contains data from July 2016 thru June 2017)
  - *Direct expenses* refer to those expenses related to fee earners (primarily the compensation and benefits costs of lawyers and other timekeepers)
  - *Indirect expenses* refer to all other expenses of the firm (including occupancy costs, administrative staff compensation and benefits, technology costs, recruiting expenses, business development costs, and the like)
- Leverage:
  - FTEs: Total Non-Partner QFEs to total Partner QFEs
  - Demand: Total hours worked by Non-Partner QFEs to total hours worked by Partner QFEs
- Profitability
  - Profits per Partner (G/L) – G/L Revenue minus all direct and indirect expenses divided by Partner FTEs
  - Profits per Equity Partner (G/L) – G/L Revenue minus all direct and indirect expenses divided by Equity Partner FTEs
  - Profit as % of Revenue (G/L) – G/L Revenue minus all expenses (Direct and Indirect) divided by G/L Revenue

A FORK IN THE ROAD

Australian law firms have traditionally been faced with a decision between two paths to follow: Whether to become a *national* firm and how, or whether to become an *international* firm and how?

With the advent of new and emerging legal technologies, the path to either of these two options has become much clearer and more defined. Firms are now able, through strategic investments, to accomplish more with less. While the old distinction between a national and international firm remains, albeit blurred, a new distinction has emerged: In this technology-enabled era, does a firm choose to be a trailblazer, or instead, a traditionalist?

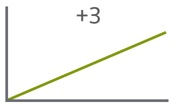
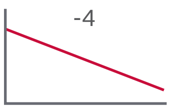
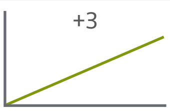
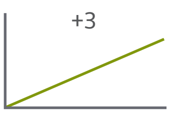
There are inherent advantages to either strategic decision. A firm opting to be a trailblazer, or leader, affords itself the opportunity to reap the benefits earlier than their peers. A traditionalist, or follower, trades that opportunity for the safety of adopting – at a later date than the trailblazers – only what has been proven to work, thereby avoiding any waste associated with failed technological adoptions.

The two divergent paths include both positive and negative implications for the firm, and it is unclear whether one strategy is preferable to another. Many of the new trends we will examine in the text to follow will have been adopted so far only by the trailblazers, while other reoccurring trends have now trickled down to the traditionalists.

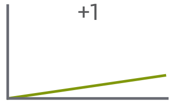
This paper will outline some of the most influential trends observed over the past financial year in the Australian legal market, and hopefully, by the end, provide some insight into which role your firm is more comfortable occupying.

Qualitiative Market Assessment

There are a significant number of macro trends impacting the Australian legal market. The table below presents the author's analysis of these trends, the trajectory of the trend line, and further commentary and evidence supporting the analysis.

Macro Trend	Pace of Change*	Comments
Lateral partner movements	+3 	• The pace of lateral hiring continued unabated over the past year. Carlyle Kingswood Global data indicates that there were 43 lateral partner movements amongst the top 50 firms in Australia for the six months to June 2017. In 2016, there were a total of 164 movements. Assuming an average practice size of $1.5 million, this represents around $250 million worth of fees transitioning across the market. • One lateral movement of note was Paul Fontanot, a forensic accounting partner from EY, moving to Clayton Utz on 1 March 2017. His move signalled the firm opening a new Forensic and Technology Services practice. Some of Fantanot's EY colleagues joined him a few months later.
Entry of global firms into the Australian market	-4 	• While there was a lot of media attention related to White & Case raiding Herbert Smith Freehills' infrastructure and project finance practice, there were no other examples of global firms entering the Australian market in the 12 months to 30 June 2017. • It is interesting to note that, to date, none of the large Asian regional firms have attempted entry into Australia.
Growth of global boutiques	+3 	• We define a global boutique as the Australian office of an international firm that practices in Australia in selected practices (not full-service), and has less than 30 partners. Firms like Clyde & Co, Jones Day, and White & Case are included in this segment. Firms like Baker McKenzie, DLA Piper, and K&L Gates are not. • There are now 20 global boutiques in Australia, including the legal practices of the Big 4 accountants. It is estimated that this segment has just under 200 partners and commands over $350 million of mostly high-margin fees. These boutiques often enjoy the benefits of a global brand, extensive client and referral networks, and superior support infrastructure. On the downside, they often have to deal with an added managerial burden and a higher administrative overhead.
Growth of country desks within domestic firms	+3 	• Anecdotal evidence suggests a significant increase in the international practices of larger nonaligned domestic law firms. Many of these firms have created "country desks" focused on particular coutries or regions, in particular, China, Japan, the Middle East, and Europe. These desks mostly facilitate legal work related to inbound investment transactions and servicing multinationals. • Many of these domestic firms are part of established global networking organisations. They also work hard at developing multiple "best friend" relationships with referral law firms in target countries.

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

<table>
<tr><th>Macro Trend</th><th>Pace of Change*</th><th>Comments</th></tr>
<tr><td>Shift of work in-house</td><td>+1
</td><td>

The June 2017 NSW Law Society report indicates a huge growth in in-house legal teams, but that the pace of change has slowed somewhat:

Solicitor employment sector in 2011, 2014 and 2016

<table>
<tr><th></th><th></th><th></th><th></th><th colspan="2">Change</th></tr>
<tr><th></th><th>2011</th><th>2014</th><th>2016</th><th>2011-14</th><th>2014-16</th></tr>
<tr><td>Private Practice</td><td>43,150</td><td>47,569</td><td>50,593</td><td>+10.2%</td><td>6.4%</td></tr>
<tr><td>Corporate</td><td>7,325</td><td>10,684</td><td>11,675</td><td>+45.9%</td><td>9.3%</td></tr>
<tr><td>Government</td><td>5,476</td><td>6,509</td><td>7,348</td><td>+18.9%</td><td>12.9%</td></tr>
<tr><td>Other</td><td>1,643</td><td>2,969</td><td>3,691</td><td>+80.7%</td><td>24.3%</td></tr>
<tr><td>Total</td><td>57,594</td><td>67,731</td><td>73,307</td><td>17.6%</td><td>8.2%</td></tr>
</table>

Recently, several senior corporate General Counsel have given presentations in which they have detailed the pressure they face to "do more with less". That is to say, to contain head count while still expanding the amount of work completed. To accomplish this, many in-house legal teams have turned to legal operations management and emerging legal technologies to improve productivity.
The 2017 ACC Australia & NZ Benchmarking report indicated that many in-house lawyers are taking on nonlegal responsibilities, including governance, compliance, risk, secretariat, privacy, and insurance matters.

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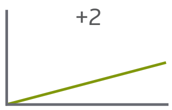
<tr><td>Rise of the large domestic business law firms</td><td>+2
</td><td>

Australian Financial Review data suggests the following changes in partner numbers in the period July 2013 to July 2017:

<table>
<tr><th>Firm</th><th>July 13</th><th>July 17</th><th>Change</th></tr>
<tr><td>HWL Ebsworth</td><td>154</td><td>219</td><td>+65</td></tr>
<tr><td>Mills Oakley</td><td>44</td><td>93</td><td>+49</td></tr>
<tr><td>Hall & Wilcox</td><td>35</td><td>70</td><td>+35</td></tr>
<tr><td>Thomson Geer</td><td>63</td><td>97</td><td>+34</td></tr>
<tr><td>Colin Biggers & Paisley</td><td>43</td><td>72</td><td>+29</td></tr>
<tr><td>Moray & Agnew</td><td>69</td><td>94</td><td>+25</td></tr>
</table>

Interestingly, the market's leading aggregator, HWL Ebsworth, hinted that the firm is aiming to grow to over 300 partners.
The grouping of firms in "tiers" 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.

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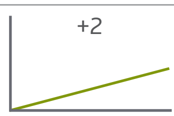
<tr><td>Growth of boutique, specialist and focus firms</td><td>+2
</td><td>

As previously touched on, the trend of significant lateral movement between firms has continued. However, this has not disrupted the trend of law firm start-ups. The traditional formula for these boutique start-up firms has been to focus on one particular work type, such as employment or corporate M&A.
The specialist patent, trademark, and intellectual property (IP) legal market in Australia has been revolutionised, with roughly 70% of the market now being serviced by ASX-listed companies. A 2016 survey by Beaton Research & Consulting indicated that many clients were unaware of the listings and didn't feel that public ownership was in their interests. Given the ill fortunes of Australia's first publicly listed law firm, Slater and Gordon, there will be much interest to see whether this ownership and governance model will be successful.

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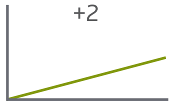
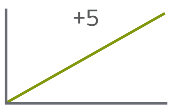
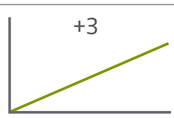
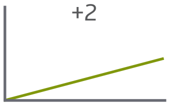
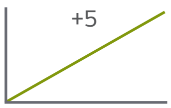
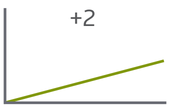
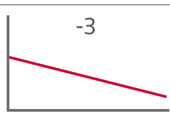
* Pace of Change: on a -5 to +5 scale, where -5 is slowing significantly and +5 is increasing significantly

Macro Trend	Pace of Change*	Comments
Growth of NewLaw	+2 	• NewLaw firms continue to make steady inroads into the Australian legal market. The ACC Australia and NZ Benchmarking report indicates that in-house legal budgeted to spend around 9% on NewLaw firms in 2017. This was up from 7% in 2015. There is also evidence that NewLaw is expanding the market for legal by tapping into the latent demand for legal services, especially from SMEs and the general public. • There is growing merger and acquisition activity amongst NewLaw providers. In September 2016, AdventBalance merged with Lawyers on Demand, and in 2017, Nexus acquired ANZ Lawyers and the Australian Lawyers Network. • 2017 saw the continued expansion of other NewLaw leaders, such as LexVoco, Keypoint, LegalVision, LawPath, and Bespoke. • NewLaw market entrants of note in 2017 include virtual IP firm, *Pearce IP*; workplace relations specialist, *Cooee*; franchise platform, *Your Law Firm*; and entreprenuer-oriented, *Law Squared*.
Growth of legal technology	+5 	• Stanford Law School's LegalTech Index now lists 721 companies across the globe developing and selling technology for the legal market. Many of these solutions have found their way into the Australian legal market. • Legal technology can be grouped into three broad categories: cognitive technologies, process technologies, and collaboration technologies. The long-term impact of cognitive technolgies is still quite uncertain, but it has the potential to be majorly disruptive to incumbent providers. • The growth of technology in law has been underpinned by five main factors: an exponential increase in the processing power of computers, the evolution of the cloud and software as a service, the pervasiveness of mobile devices, an increase in competitve pressures to reduce costs, and client connectivity and the super-profit margins enjoyed by many law firms. • Many of the larger law firms in Australia have dedicated legal technology development teams that combine legal, legal project management, data analytics, and IT skills. Allens has a team of over 50 in its Arrow and LawLab division. Gilbert + Tobin has employed ex-McKinsey consultant Sam Nickless to lead its G+Ti initiatives. He was also appointed a partner in the firm in June 2017. • Two other interesting developments in the legal technology space: – In July 2017, MinterEllison acquired a technology consultancy, IT NewCom, to provide legal-related technology advice and solutions to its clients. – Mills Oakley took a 7% equity stake in two legal tech start-ups: [1] Speak With Scout, giving personalised legal guidance to consumers researching online, and [2] ContractProbe, an automator of contract reviews.
Growth of innovation as a strategic theme	+3 	• Many firms have added or elevated *innovation* as a major element of their business strategy. There is no uniform approach, but many firms are experimenting with innovation committees, shark-tank-type innovation competitions, hackathons, app development and incubators. Hall & Wilcox has added "Smarter Law" to its tagline to position the firm externally as a leader in the innovation space. • In February 2017, the College of Law established a new Centre for Law Firm Innovation, aimed at capturing and sharing better innovation practices across the legal market.

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

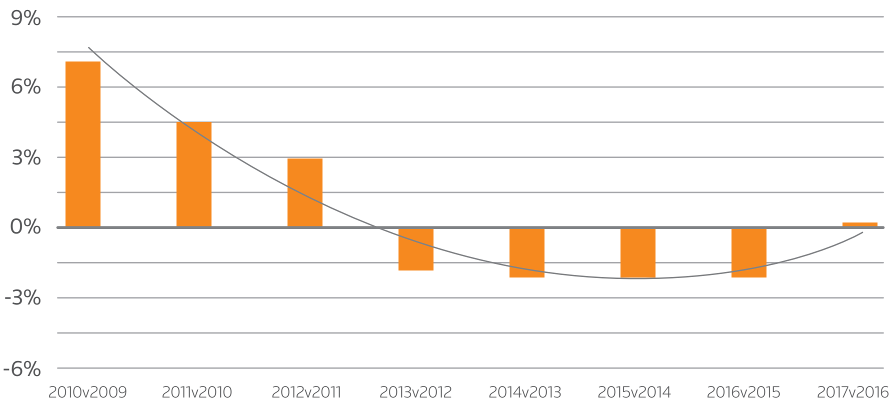
Macro Trend	Pace of Change*	Comments
Growth of MDPs and law firm diversification	+2 	• The top end of the legal market faced increased competition from PwC, KPMG, EY, and Deloitte. In some markets, this is direct competion, such as PwC Legal which now has over 20 partners focused on M&A, international and domestic tax, corporate finance, and regulatory and employment law. Both the top law firms and the Big 4 are competing for quasi-legal compliance, forensics, risk, and investigations work. Some commentators have noted that the growth of the accountants in legal is constrained, given the depth and range of their client conflicts. • The Big 4 have always competed with the lawyers in tax, and the movement of tax specialists between the sectors continued in 2016/2017. • MinterEllison has entered the multidisciplinary space with acquisitions of an executive remuneration advisory firm and a technology consultancy. • Sparke Helmore established an innovation consultancy, Bright Sparke, to assist clients with e-discovery and legal process redesign. • In July 2017, Pinsent Masons announced the acquisition of diversity and inclusion consultancy, Brook Graham.
Supply of legal graduates	+5 	• There are now 39 law schools in Australia producing over 7,500 graduates per annum. While many of the larger firms increased their 2017 graduate intake over previous years, a number of law graduates still struggle to find clerkships and full-time employment in traditional law firm roles. • Many Australian law schools are adding legal technology and legal app development to their curricula. Others have added internships and other short-term contract models to improve the prospects of employability.
Focus of talent diversity	+2 	• The 2017 NSW Law Society report indicated that, for the first time, there are now more female than male legal practitioners in Australia. • The 2017 Australian Financial Review 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 1 July 2017. This is almost exactly the same proportion as in 2016. • Women increasingly sit at the highest echelons in major firms. In May 2017, King & Wood Mallesons appointed Sue Kench to global managing partner; in April, Maddocks re-appointed Michelle Dixon to CEO; in December 2016, Melinda Upton was appointed co-head of DLA Piper's Australian arm; and Asia and Australia regional managing partner for Herbert Smith Freehills is Sue Gilchrist. Loretta Reynolds has been Thomson Geer's chair for a decade; Lander & Rogers chair is Genevieve Collins; and Allens appointed Fiona Crosbie to chair last year.
Use of off-shore LPOs	-3 	• Due to the fall in the Australian dollar, and increasing levels of competition from on-shore operations, the demand for off-shore legal process operations (LPOs) in locations such as India, South Africa, and the Philippines has diminished. • Unison, an Australian on-shore LPO, appears to be gaining strength.
Growth of legal project management	+2 	• A large number of firms are increasing the amount they invest in legal project management training and tools in response to increasing levels of client demands for more accurate price estimation and resource planning. • It's worthy of note that Allens' Arrow and LawLab teams have over 70 staff. This includes specialist legal project managers, data scientists, paralegals, and change consultants.

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

Quantitative Market Assessment

For most of the previous decade, year-to-year demand contracted in the Australian legal industry. However, financial year 2017 was perhaps the inflection point where this trend reversed: Demand across all segments was essentially flat relative to FY2016, growing by 0.1% on average (Chart 1).

Chart 1: Change in Annual Demand 2009-2017



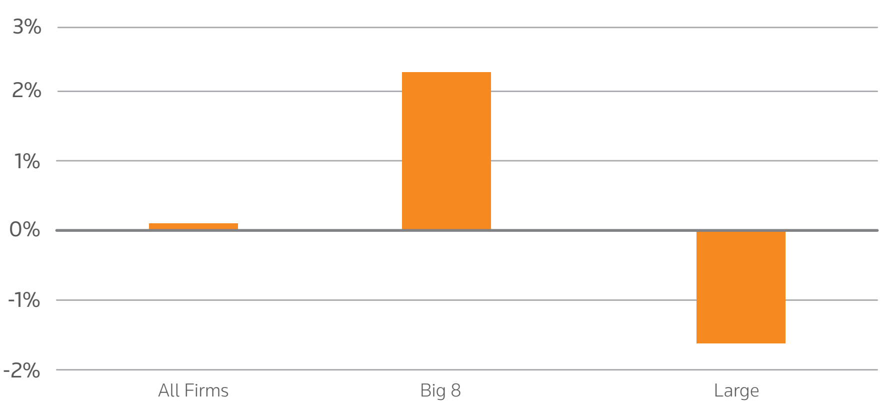
Source: Thomson Reuters Peer Monitor All fee earners/billable time type/AU offices

Consistent with FY2016, Big 8 firms outperformed their Large counterparts, in this instance significantly. Demand increased for Big 8 firms on average by 2.2% overall (Chart 2). Conversely, in the Large segment, demand contracted by 1.6% over the same time period.

Revenue in the legal industry seems to be following a similar path to that of market demand, with growth for the year, again, flat (0.0%). When segmented, similar to demand, Big 8 firms experienced revenue growth of 1.6% over FY2016, while Large firms revenue receded by an average of 1.3%.

Overall, qualified fee earner (QFE) head count growth is also juxtaposed between the two segments. A decrease of 0.5%, a product of 1.0% growth in the Big 8 segment and a 1.6% decrease amongst Large firms, was observed over the course of the financial year.

Chart 2: Demand Growth by Segment FY 2017 v 2016



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

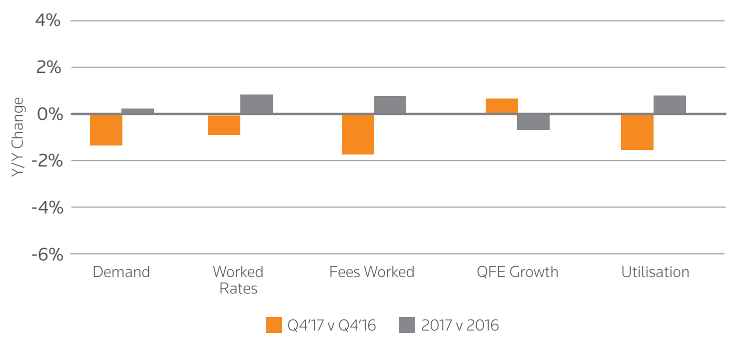
Key Performance Indicators

Despite an overall lacklustre fourth quarter, four out of the five key performance indicators finished the year with positive, albeit slight, growth (Chart 3). Demand, worked rates, fees worked, and utilisation all had positive growth for FY2017, but none greater than 1%. The only remaining KPI, QFE growth, decreased by 0.5% even with a positive fourth quarter. It is quite likely that this decrease in QFE growth is responsible for the positive growth seen in average utilisation, even in a market with essentially flat demand.

The firms in the Big 8 had positive growth in four out of five KPIs in the fourth quarter, and all five when averaged for the year (Chart 4). Overall, both demand and fees worked increased by more than 2% in 2017, while QFE growth and utilisation both grew by 1% or greater. Worked rates were also positive, increasing by 0.4% over the course of the financial year.

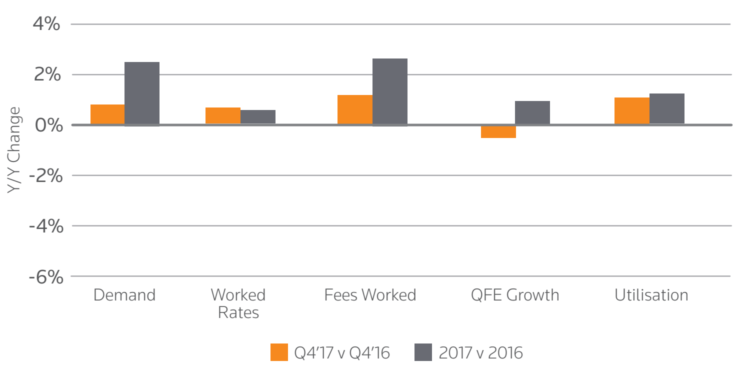
Hampered by a difficult final quarter in which four of five KPIs declined, the average Large firm was faced with overall contractions in demand, fees worked, and QFE head count. The fourth quarter saw demand, fees worked, and utilisation all decrease by more than 2% relative to the final quarter of the previous financial year (Chart 5). Despite all of this, overall worked rates and utilisation remained slightly positive, with growth of 0.4% and 0.04% respectively.

Chart 3: Key Performance Indicators: All Segments



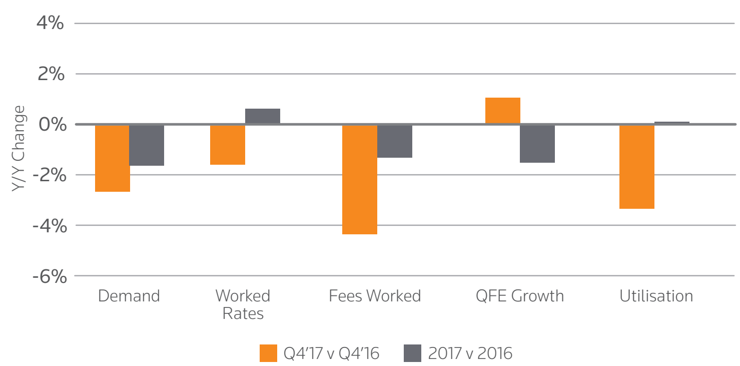
Source: Thomson Reuters Peer Monitor All fee earners/billable time type/AU offices only

Chart 4: Key Performance Indicators: Big 8



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

Chart 5: Key Performance Indicators: Large

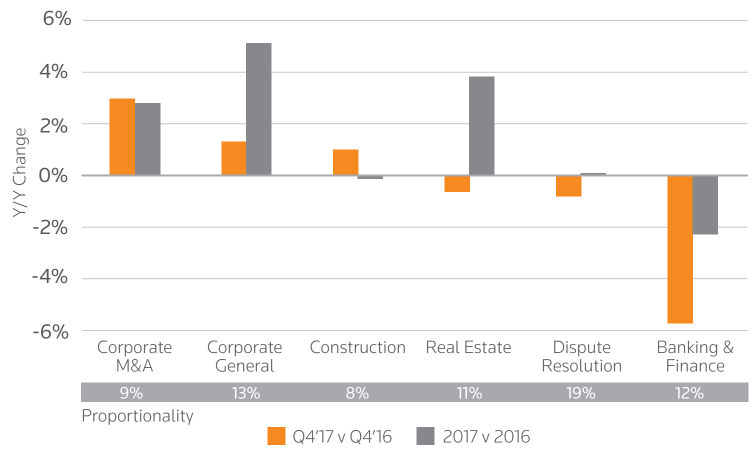


Source: Thomson Reuters Peer Monitor All fee earners/billable time type/AU offices only

Practice Demand

With demand essentially flat, demand among the various practices tracked by Peer Monitor has been a mixed bag. Certain practices enjoyed minimal to marginal gains, while others saw their overall performance dip considerably (Chart 6). Large levels of variability existed in practices across both segments from quarter to quarter. As with demand and revenue, practice demand growth was very segment specific, with the majority of the successes congregating amongst the firms in the Big 8.

Chart 6: Practice Demand Growth



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

CORPORATE GENERAL/M&A

Some of the most significant growths in practice demand this year were in corporate work, both in corporate general and corporate M&A categories. In the fourth quarter, corporate general demand increased 1.3%, while M&A was up 3.2%. This strong ending to the financial year resulted in 2.8% growth for the year in M&A, and 4.9% in corporate general. Significant growth in these categories is music to most firms' ears, as together these two practices comprise approximately 24% of all hours worked in the market tracked by Peer Monitor.

CONSTRUCTION

After a year in which much of the practice related discussion revolved around construction, overall demand ended the year slightly negative, decreasing by 0.2%. Many pundits have tried to call the top of the market during the construction boom, but it is unclear if that point has actually been reached or if the decrease is a result of significant work being done in years prior.

REAL ESTATE

Despite a down fourth quarter where hours worked in the practice decreased by 0.7% relative to the year prior, real estate practice demand ended the year up 3.8%. Similar to construction, it is unclear if growth in the real estate market is sustainable long term, due to factors such as increasing levels of government oversight. Real estate work currently makes up approximately 11% of the total market tracked by Peer Monitor.

DISPUTE RESOLUTION

Dispute resolution, suffering from a weak fourth quarter where demand decreased by 1.0% relative to the previous year, was stagnant overall. With dispute resolution constituting a significant portion of overall market demand, approximately 19%, demand stagnation is preferable to contraction. Demand for dispute resolution was very geocentric, with significant growth of 12.4% occurring in Perth, juxtaposed with a decrease of -5.1% in Brisbane.

BANKING AND FINANCE

On the opposite end of the spectrum, banking and finance suffered through significant demand contractions in financial year 2017. As a result of a significant decline of 5.6% in the fourth quarter, average hours worked in the market for the year decreased by 2.4%. Banking and finance comprises about 12% of total practice demand in the AU market tracked by Peer Monitor.

Utilisation

In financial year 2017, utilisation per QFE followed a similar pattern as years past. When looking at the differences between utilisation in the two segments, measured by average hours worked per QFE, a continually widening gap is readily noticeable.

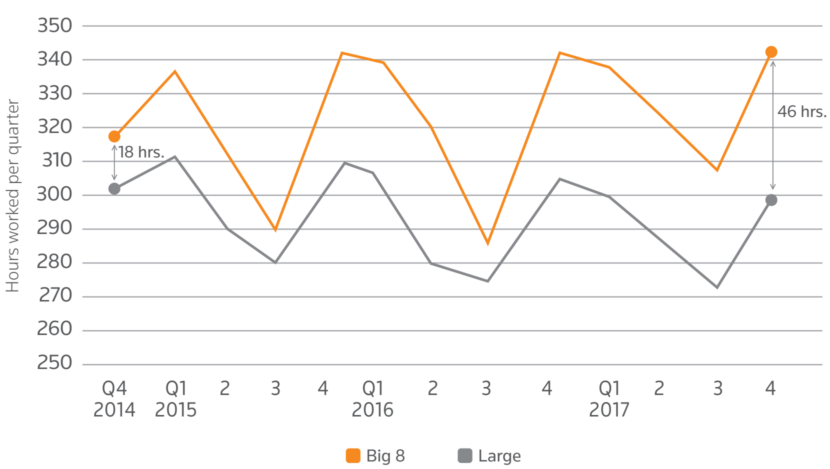
In the fourth quarter of 2014, the average QFE in the Large segment worked 290 hours (Chart 7). Conversely, the average QFE at a Big 8 firm worked 310 hours, or 20 more than their Large counterparts. Firms in the Big 8 have since increased the difference between segments from 20 to 45 hours per QFE. This is a significant gap, and is just one attribute that gives firms in the Big 8 the ability to operate at higher profitability levels than the average firm in the Large segment.

Chart 7: Utilisation – Qualified Fee Earners

Source: Thomson Reuters Peer Monitor All qualified fee earners/billable time type/AU offices only (hours worked per qualified fee earner)

The difference between segments is only further magnified when dialled down to the associate class only. Associates are the traditional candidates for partners to leverage to increase profitability. The discrepancy between Large and Big 8 firms has increased over the last 39 months from 18 hours to 46 hours, with firms in the Big 8 utilising their QFEs in the associate rank significantly more (Chart 8).

Chart 8: Utilisation – All Associates



Source: Thomson Reuters Peer Monitor AU offices only; billable time type; associates + sr. associates (hours worked per associate)

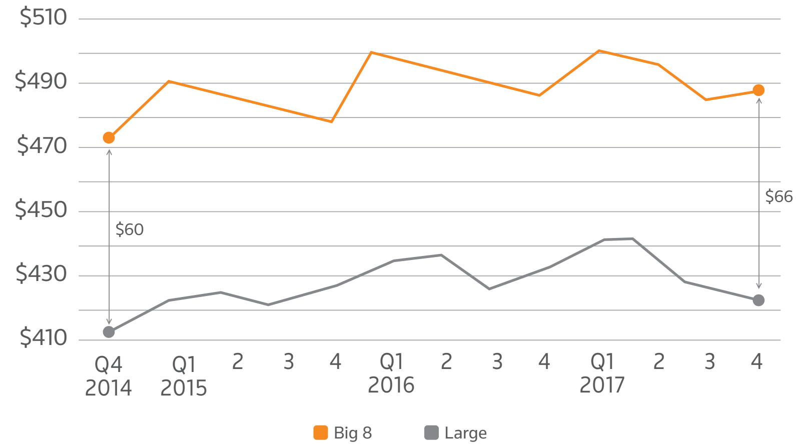
Rates and Realisation

Worked rates (defined as the average rate the client agrees to pay to engage work) followed a similar trend, but not on the same scale as that of utilisation. The disparity between segments in worked rates has increased from $60 to $66, with the Big 8 firms on average charging $489, and Large firms $423 (Chart 9).

Interestingly, however, the opposite has occurred one rung down the rates-ladder. The average billed rates in the Big 8 amongst all QFE's has increased only 8 dollars since the fourth quarter of 2014, increasing from $415 to $423 (Chart 10). The average Large firm has increased their billed rates $14 over the same time period, from $363 to $377. In the case of billed rates, the gap between the Big 8 and Large firms is actually shrinking, as opposed to widening.

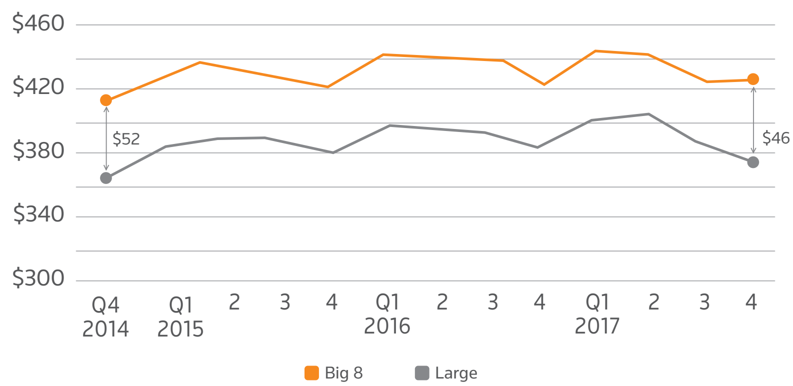
Over the course of the year, billing vs agreed realisation in the Big 8 fluctuated from 81% in Q1 to 83% in Q4 (Chart 11). Whereas over the same period, Large firm realisation went from 92% to 91%. Large firms are seemingly much more able to realise larger portions of their worked or agreed rates, which could be attributed to the lower dollar values they charge on average, though it is impossible to know for sure.

Chart 9: Worked Rate Progression



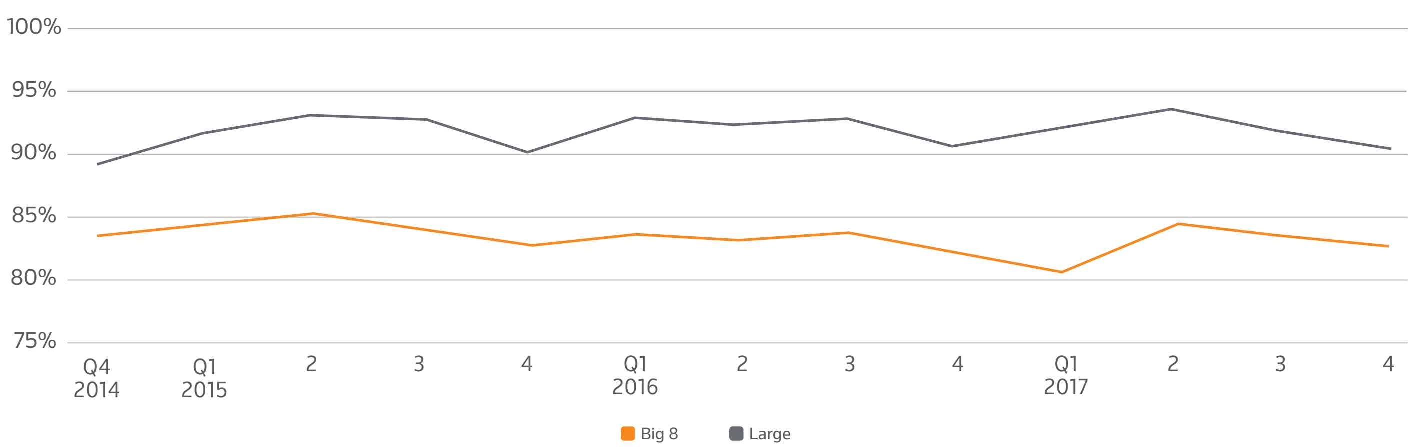
Source: Thomson Reuters Peer Monitor AU offices only; billable time type; qualified fee earners

Chart 10: Billed Rate Progression



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

Chart 11: Billed Rate Realisation Against Agreed



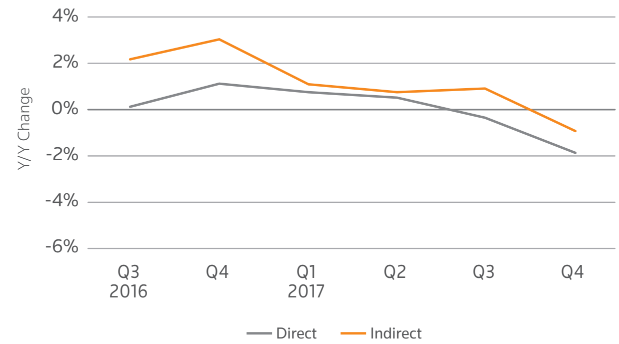
Source: Thomson Reuters Peer Monitor AU offices only; billable time type; qualified fee earners

Expenses

Whereas certain levers of profitability, such as demand, are not directly controllable by the firm, others such as expenses are. Cutting unnecessary expenditures is seen as a relatively easy way to increase overall firm profitability. Further, targeted increases in expenditure, in areas such as technology, has led to decreases in others. This is readily observable throughout the market where the average firm decreased their overall spend on both direct and indirect expenses over the last 12 months (Chart 12).

The average firm in the Big 8 is not yet contracting either indirect or direct expenses. Instead they are increasing them both, but now at a slower rate. Direct expenses increased in the fourth quarter by 2.5%, a significantly slower pace than the 4.4% increase seen in Q3 (Chart 13). Similarly, indirect expenses increased by only 0.9% in Q4, a decrease from the 3.3% seen in Q3.

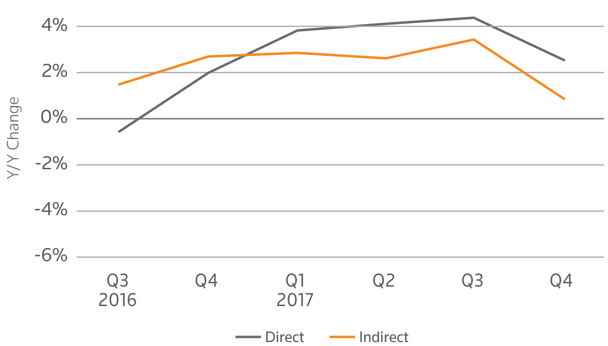
Chart 12: Expense Growth – All Segments*



Source: Thomson Reuters Peer Monitor

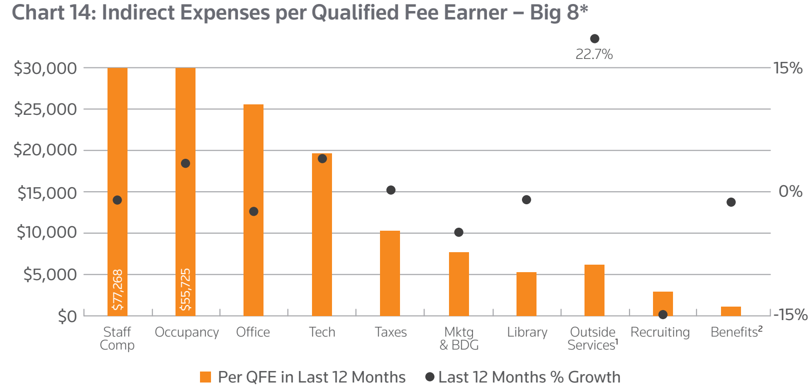
The largest increases in Big 8 indirect spend per QFE came in technology and outside services, with the former increasing by 3.5% and latter by 22.7% over the last 12 months (Chart 14). These are both potential examples of targeted expenditure increases which allow the firm to operate more efficiently.

Chart 13: Expense Growth – Big 8*



Source: Thomson Reuters Peer Monitor

Chart 14: Indirect Expenses per Qualified Fee Earner – Big 8*

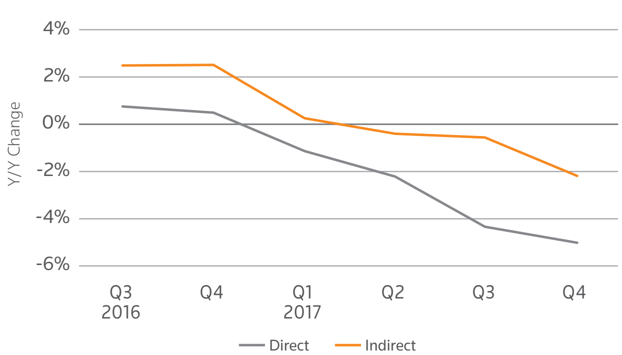


Source: Thomson Reuters Peer Monitor

Both direct and indirect expenses tapered in the Large segment during 2017, with only one quarter (Q1) showing growth for indirect expenses relative to the year (Chart 15). Direct expenses decreased in all four quarters, a product of declining QFE head count throughout the segment (-1.6%) for the year. Indirect expenses receded for 3 out of the 4 quarters.

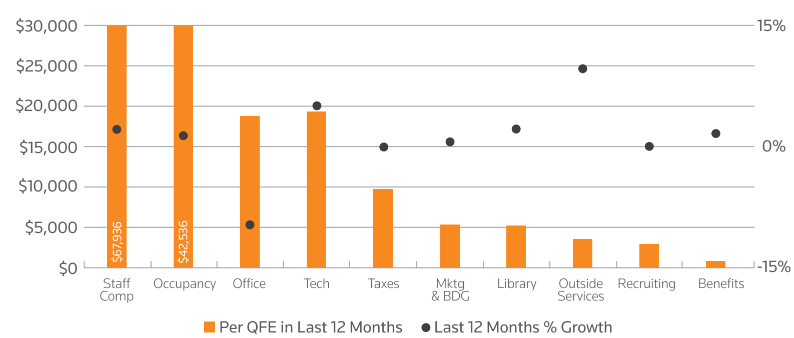
Similar to the Big 8, the largest increases in expenditure per QFE were again technology and outside services (Chart 16). Technology spend per QFE increased by 5.5% in 2017, now totaling $19,345, while outside services spend increased by 9.6%.

Chart 15: Expense Growth – Large*



Source: Thomson Reuters Peer Monitor

Chart 16: Indirect Expenses per Qualified Fee Earner – Large*



Source: Thomson Reuters Peer Monitor

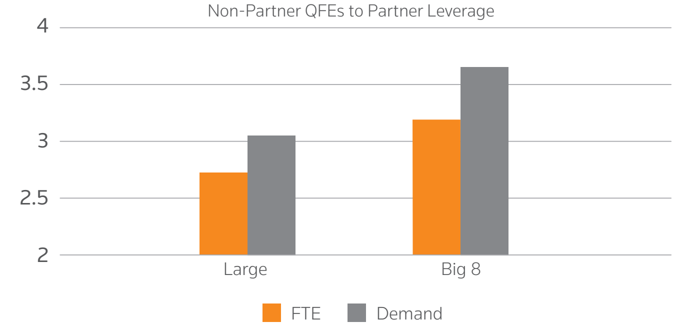
*All expenses constitute rolling 12-month periods/AU offices. [1]This includes outsourced services for mail room, copy centre, and records management, etc. This also includes professional services such as tax return preparation, outside legal services, payroll processing, trust administration expenses, employee benefit consulting, and other consulting services. This does not include outsourced technology functions, or outsourced marketing functions. This category does not include temporary help. [2]This includes firm-paid employee insurance, firm-paid retirement benefits, and other firm-paid benefits.

Leverage

Firms in the Big 8 had much higher leverage than their Large counterparts in 2017, measured by total non-partner QFEs to total partners, in terms of head count as well as hours worked (Chart 17). The average Big 8 firm employed 3.23 non-partner QFEs to every partner, whereas their hours worked equated to 3.64 between the same two groups. Firms in the Large segment had a head count leverage of 2.73, and 3.02 hours worked between non-partner QFEs and partners.

This significant difference in leverage, in both head count and demand, was one of the driving factors in the different levels of profitability observed between the two segments. The demand leverage ratios from both segments indicate that non-partner QFEs are required to work a slightly disproportionate volume of hours compared to their respective head count ratios.

Chart 17: Leverage by Segment



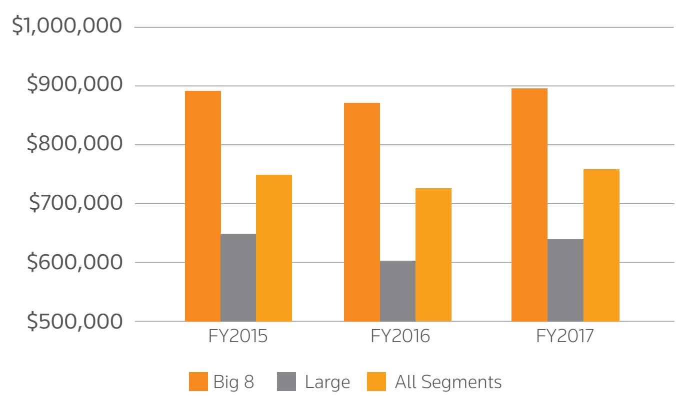
Source: Thomson Reuters Peer Monitor Qualified fee earners; billable time type; AU offices

Profitability

Firms across all segments increased their profitability in 2017, increasing profit per partner on average by 3.6%. Large segment firms enjoyed a large increase in PPP, with average growth of 4.7% or about $30,000 per partner (Chart 18). Firms in the Big 8 also found positive growth in the category, increasing by 2.7% for the year.

Growth in the average Big 8 firm is magnified when looking instead at profit per equity partner, due in large part to the practice of de-equitization within the segment. This is evidenced in the segment by an average decrease of 2.8% in the equity partner category, coupled with an average growth of 8.9% in the non-equity partner ranks. PPEP in the Big 8 grew by 5.1% relative to 2016, an increase of about $47,000 per equity partner (Chart 19). Large firms increased their PPEP significantly as well, growing by 4%, or about $30,000.

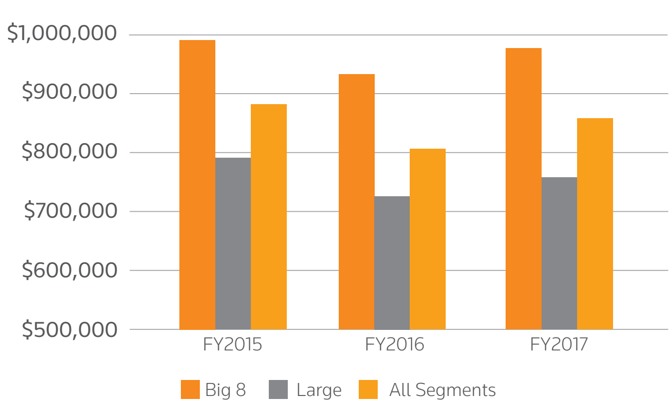
Chart 18: Profit per Partner



Source: Thomson Reuters Peer Monitor G/L Fee Revenue, AU offices

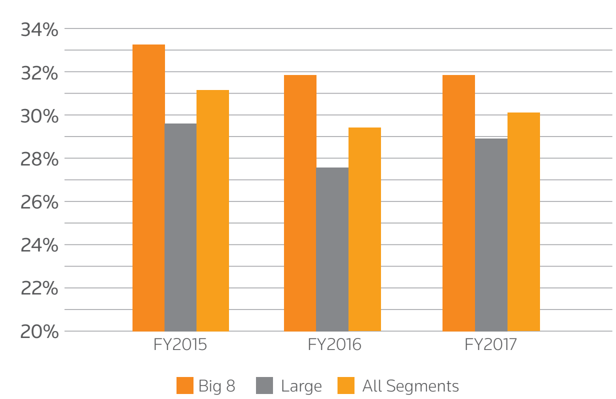
When comparing overall profit as a percentage of revenue, we see that the average for all firms has increased from 29.4% in FY2016, to 30.2% in FY2017 (Chart 20). However, this growth was segment-specific. In both years, the average Big 8 firms' profit accounted for 31.8% of revenue. At the same time, the average Large firm increased their average profit from 27.5% to 28.9% of their revenue. This increase is closely associated with the decrease in total expenses for Large firms over the same time period.

Chart 19: Profit per Equity Partner



Source: Thomson Reuters Peer Monitor G/L Fee Revenue, AU offices

Chart 20: Profit as a Percent of Revenue



Source: Thomson Reuters Peer Monitor G/L Fee Revenue, AU offices

In Conclusion

Over the past 30 years, larger law firms in Australia have had to make only two major strategic decisions: [1] whether to become a national firm and how, and [2] whether to become an international firm and how?

They now have to make a third.

The 2017 Peer Monitor data leaves little doubt that technology is changing the practice and business of law and that firms need a clear and coherent strategic response. Firms might decide to be pioneers investing in lawtech start-ups, teaching their lawyers how to code and experimenting with new cognitive technologies. Other firms might prefer to keep their powder dry and wait to see what works, which platforms take hold, and what their clients prefer. Either way, an active choice needs to be made. Each comes with their own risks and opportunities.

A key challenge in investing in a new way is that the current core business is still very successful. The 2017 Peer Monitor data suggests that despite a flat market overall, a fair number of firms are still making healthy profits. The challenge comes in balancing the old with the new.

One way for firms to address this balance is to think about strategy as two parallel streams: one being Exploit and the other Explore (based on the work of O'Reilly and Tushman). Exploit refers to efforts to leverage current strengths and capabilities to make the current core business as good as it can be. Explore refers to new exploratory and experimentation efforts that will hopefully bear fruit in the future.

One approach is to make the whole firm ambidextrous, that is, change the firm's culture so that everyone embraces Explore AND Exploit in their everyday work and client interactions. An alternative approach is to keep the Explore and Exploit far from each other and avoid cross-contamination. In this instance, Exploit is the cash cow and hires the suits, and Explore is a cash burner and hires the black skivvies. A third approach is to try to do both.

In an environment of rapid change and hyper-competition, every firm needs a healthy portfolio of both Exploit and Explore initiatives. A genuine commitment to Explore will most likely mean substantial changes to the firm's dividend policy and capital structure. Firm governance and structural arrangements are also likely to be impacted, as will marketing, pricing, finance, operational, and HR.

The role of managing partners is to lead the thinking around these issues and prepare the firm for its third really big strategic decision.

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