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STORM WARNINGS

For the first time in six years, law firm expenses are growing faster than revenues.

By Dan DiPietro

SOONER OR LATER, IT WAS BOUND TO happen. After six years of keeping expenses down—largely through eschewing the associate salary wars of the late 1990s and dramatic ramp-ups in head count—law firms unloosened the purse strings. First-year associate salaries rose sharply, especially among Am Law 100 firms. So did hiring numbers. Both moves were made in anticipation of a law firm economy that would continue to produce the roughly double-digit increases in profits and gross revenues the industry has enjoyed over the last six years.

It certainly seemed like a reasonable assumption, given the strength of the legal economy in recent years. That strong revenue growth continued through the first six months of the year, according to data reported by the Law Firm Group at Citi Private Bank in our latest flash report. But for the first time since 2001, expense growth actually outpaced that of revenue from January through June, depressing profit margins. This could be the first sign that firms face rough seas ahead. The first half of 2007 did provide firms with enough momentum to produce what we believe will be respectable profit growth for the year, if not the gaudy increases firms have become accustomed to since 2001. However, in the second half of 2007, expenses will almost certainly continue their climb, propelled by the costs of associate salary increases and rising attorney numbers, along with escalating real estate and technology costs. On the revenue side, transactional work has dropped off sharply as the mortgage lending credit crisis continues to play out. And those old stalwarts of an economic slowdown—litigation and bankruptcy—have yet to fill in the gap created by the absence of transactional work. Unless business picks up, firms could find themselves struggling a bit in 2008.

Citi Private Bank provides financial services to more than 600 U.S. and British law firms and more than 35,000 individual lawyers. Each quarter, the Law Firm Group of Citi Private Bank confidentially surveys firms in The Am Law 100 and Second Hundred, along with smaller firms. In addition, we conduct a more detailed annual survey. These reports, together with extensive discussions with law firm management conducted on an ongoing basis, provide a comprehensive overview of financial trends in the industry and insight into where it is headed.

Our report found that, across the sector, gross revenue growth in the first half of 2007 came in at a strong 13.1 percent, well above the compound annual growth rate (CAGR) of 10.5 percent of the prior three years. The growth was driven by a strong pickup in transactional work, boosting gross billable hours. Rate increases of just less than 7 percent, in line with the six-year CAGR of 7 percent, contributed to revenue growth at parity with gross hours. A hiring spree also helped boost leverage—total lawyer counts rose by 7.4 percent, significantly above the growth rate of equity partners—continuing the upward trend of the previous two years.

But strong revenue growth was tempered by big increases on the expense side. A 13.7 percent increase in expenses in the first half of the year—compared with the three-year expense CAGR of 9.2 percent—anchored the drag on profits. In fact, for the first time in six years, the growth rate in expenses exceeded that of revenues, both overall and as measured on a per-lawyer basis. A whopping 17 percent rise in compensation costs accounted for the bulk of the increase in expenses. This is well ahead of the three-year CAGR of 9 percent. The driving factor: an associate salary arms race set off in January, which pushed first-year salaries at many New York and California firms up to $160,000, from $145,000 in 2006. The increase had probably been overdue—from about 2000 to 2005, the first-year base salary had remained at $125,000—but its impact on profits is being felt nonetheless (about 23 percent of firm revenue goes to compensation). Operating costs—or occupancy charges and overhead—also grew by close to 12 percent. The upsurge was driven largely by new lawyer hires requiring firms to expand office space and technology. In addition, a fair amount of the growth, at least among The Am Law 100, happened outside the United States. Because of the weak dollar, to the extent overseas office space had to be paid for in U.S. dollars, firms took a hit.

Productivity, or average hours per lawyer, was flat compared to 2006—actually a good sign when the rapid lawyer growth is considered. The profit pie, however, will be sliced thinner due to an equity partner growth rate in the first half of 2007 of 1.5 percent, up from last year's equity partner increase of just over 0.5 percent.

But note: This year's larger class of equity partners still trails the six-year CAGR of 2.6 percent.

When the firms in our sample are broken out by size, significant differences appear. Our sample of 144 firms includes 62 in The Am Law 100, 45 in the Second Hundred, and 35 smaller firms that we characterize as "Other" for these purposes. Our survey shows that the 35 Other firms did notably worse than their larger rivals. In the first half of the year, both Am Law 100 and Second Hundred firms in our survey recorded double-digit revenue growth (divided almost equally between gross hours and rate increases), while Other firms saw less than 5 percent growth, much of which was driven by rate increases. Although the Am Law 100 and Second Hundred firms both saw double-digit increases in total expenses, Other firms were able to keep expense growth around 6 percent largely by minimizing the increase in operating costs, which is a function of growth in head count.

The smaller firms grew the slowest, increasing total lawyer head count by a little more than 1 percent, versus 7.4 percent for the Am Law 100 firms and 5.6 percent for the Second Hundred firms. A look at compensation expenses reveals that although Am Law 100 firms were hit hardest by the salary wars—they saw such costs rise by a whopping 18.4 percent—their smaller competitors were not exempt. Compensation rose by around 13 percent for firms in the Second Hundred and 10 percent for Other firms. Nonetheless, the significantly weaker revenue growth among Other firms meant that contribution per lawyer actually declined by almost 2 percent, while their bigger rivals enjoyed growth rates of 4–5 percent.

Our regional data points out another important difference. Firms headquartered in New York are among the few in the country where revenue growth exceeds that of expense. That is an indication that these firms have done a better job absorbing associate salary increases and have had enough work to keep them busy and billing.

Although we don't have the final numbers yet, my discussions with managing partners and other law firm management suggest that the second half of the year will look dramatically different from the first half. While productivity was flat year-to-year for the first six months of 2007, I expect it to go into negative territory in the second half, driven down by the sharp drop-off in transactional work. At the same time, litigation and bankruptcy work have yet to pick up the slack. This trend may actually affect the Am Law 100 firms the most, since transactions are such an important driver of their business. Expense growth, too, will continue to climb, as the impact of salary increases will be more fully felt. Also, Cravath's announcement of generous associate bonuses will likely put even greater pressure on expenses.

Still, revenue growth should remain relatively strong in the second half of the year, as a result of notably higher inventory levels as of June 30. Inventory—accounts receivable and unbilled time (time worked but not yet billed to the client)—rose by more than 13 percent in the first half of the year, suggesting continued revenue momentum in the third and fourth quarters. The exception are the Other firms in our survey, which saw only a 6.3 percent rise in accounts receivables and a less than 1 percent rise in unbilled time. The weak inventory numbers, which serve as an excellent predictor of future revenue collections, point to a falloff in revenue growth for these firms in the second half of 2007.

Overall, however, I expect firms to report increased profits per equity partner of 6–8 percent. They may not be the headline-grabbing double-digit numbers of previous years, but they are certainly respectable.

But 2008 is rife with uncertainty. Collections should carry most firm revenues through the end of the year, but not beyond. Will a slowdown in work necessitate layoffs, just as leverage growth reached the levels of 2001? If transactional work doesn't return and litigation and bankruptcy remain soft, what will be the rescuing countercyclical practice? Firms are anxiously waiting to see whether the slowdown is just a blip or more systemic. Let's hope it's the former.

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