Acritas

LEGAL EXECUTIVE INSTITUTE

PEER MONITOR

State of the Legal Market in the UK:
Challenges to Growth and Sustainability

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Executive Summary

The UK legal market has a good track record of growth, with revenues up again in 2018-19. The local market is dominated by some of the world's largest law firms, and the UK's largest firms are also dominant players on the global field. The Magic Circle firms enjoy excellent brand awareness that puts them on par with (traditionally more visible) professional service brands in the areas of consulting, finance, and accounting. UK-led firms just outside the Magic Circle have also become globally recognised as they have merged and gained scale across multiple jurisdictions.

As a result of Brexit, the future of the UK domestic economy is uncertain, with many expert commentators making gloomy predictions. Firms with a global presence and strong reputations are likely to have a more positive outlook, as they will be better positioned to balance growth in other markets against a potential contraction in the UK. Brexit will undoubtedly bring an inflow of work for law firms in helping clients prepare for a new operating model, but longer term, law firms are likely to need to win market share from rivals, rather than rely on the size of the market increasing, as a source of growth.

To make matters worse, competition has intensified as the UK experienced a surge of new entrants in the form of new law companies, seen a renewed focus on legal from the large accounting firms, and watched US law firms take market share through aggressive lateral hiring. Taken together with the efficiency gains more nimble firms are getting from leveraging technology across the industry, and the next decade clearly is not going to be plain sailing for UK law firms.

"Firms with a global presence and strong reputations are likely to have a more positive outlook, as they will be better positioned to balance growth in other markets against a potential contraction in the UK."

A closer look at the numbers — through data from Thomson Reuters Peer Monitor and Acritas — indicates there is no room for complacency in legal boardrooms. Partners should be asking themselves and their colleagues where the next growth area will be and how their business model will need to change to be in the best possible position for achieving growth and sustainability. Key trends that the data points to include:

- The largest clients are cutting their legal costs in a drive for efficiency;
- US firms are moving into the UK market aggressively, taking market share in specific areas, even where the market is not growing;
- Alternative legal service providers (ALSPs), although representing a small proportion of the legal ecosystem at present, are increasing their revenues quickly;
- Talent is becoming increasingly mobile; and
- Under-investment in technology carries the risk that UK law firms are falling behind new competitors and their own clients.

Some firms are already tackling these issues, and our data suggests others should focus on the following areas:

- Brand visibility and stand-out opportunities;
- Talent engagement and retention;
- Collaboration and alliances with both new law companies and tech providers; and
- Greater focus on adapting to client needs and changing expectations.

The legal market is not immune to the disruptions and changes taking place across the business world. There will always be a demand for legal expertise of course, but those law firms that ignore the forces of change may find themselves pushed to the margin as other competitors respond better and faster to market demands.

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Our research suggests there are three internal challenges and two external forces that UK firms need to understand as they plan for the future. We take a look at these over the following pages.

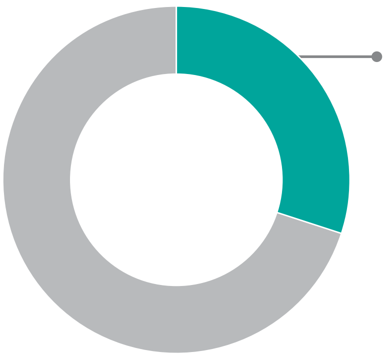
Internal Challenges: Mobility of talent; Falling utilisation; and Investment in new technology

External Challenges: New entrants into the market and Meeting client needs

INTERNAL CHALLENGE #1

Mobility of talent: US firms snapping up talent as UK firms fail to offer partnerships early enough

Law firms depend on their Stars – their stand-out talent – for client relationships and expertise. Data on the movement of such Stars in the UK shows that US firms are gaining overall. According to Acritas, of the 100 Star lawyers that switched firms, 16% were from US firms and 83% were from UK firms. When we look at where they moved to, 30% went to US firms — almost double the portion that left US firms.



Of the 100 Star lawyers that switched firms, 30% went to US firms.

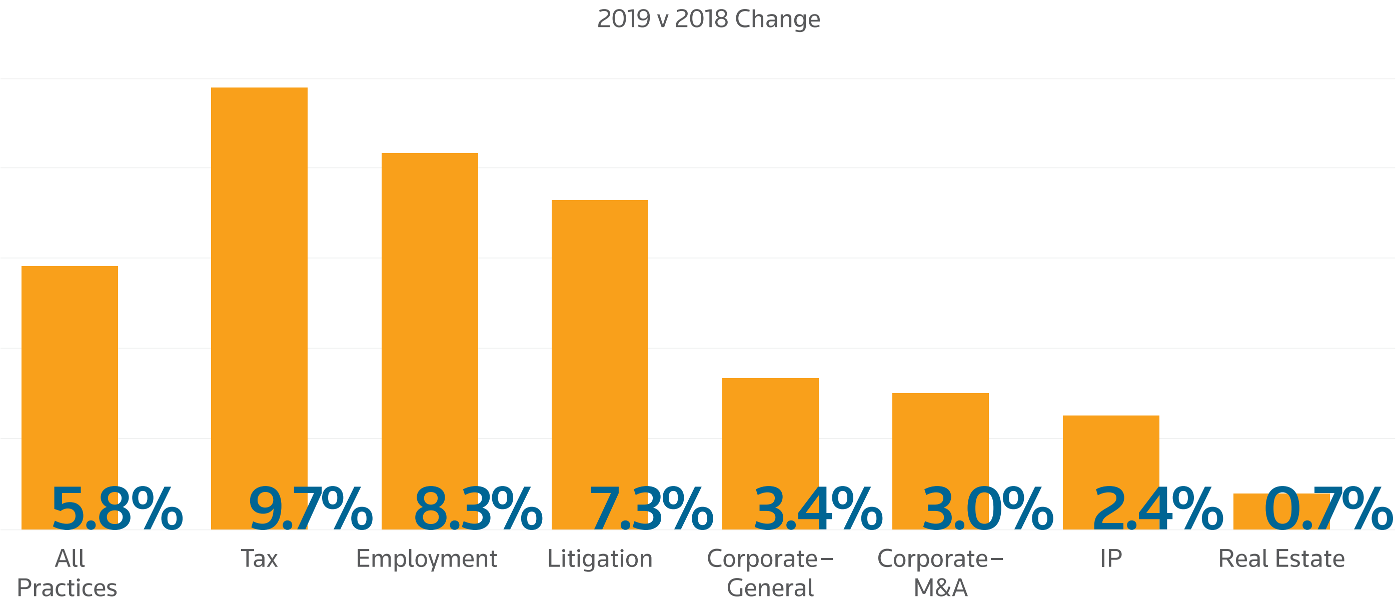
Acritas UK-based, client-nominated Stars	Original firm	New firm/organisation
100 have moved firms	UK: 83	UK: 59
	US: 16	US: 30
	London office of German firm: 1	In-house: 9
		London office of Chinese firm: 1
		Back to university: 1

Source: Acritas Stars Survey

US-based firms operating in the UK averaged 5.8% lawyer growth, significantly outpacing the 2% headcount increase at these firms on average in the US. More specifically, lawyers are significantly being hired in tax, employment, and litigation practices, where lawyer headcount has increased by more than 7% on average in all three of these practice areas.

"…these 'mobile' Stars had been Associates…and were moving to take up a partnership at their new firms."

Lawyer Growth by Practice



US-based firm activity in London
Lawyers
No contractors

Source: Thomson Reuters Peer Monitor®

Our research also shows that many of these "mobile" Stars had been Associates at their previous firms and were moving to take up a partnership at their new firms. Perhaps the obsessive focus among UK law firms on minimising partner numbers in order to maximise short-term profits-per-equity-partner (PEP) is creating a loss of talent which can only be detrimental in the long term.

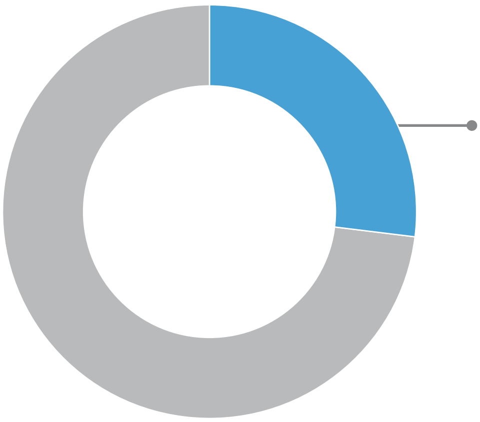
In-house legal departments were also winning from this migration of talent. For US firms that lost Stars, a disproportionate number moved in-house. Of course, migration to in-house can often bring work opportunities, when handled in the right way.

When considering lateral movement, the prospective firm's reputation and standing in the market is the main consideration for stand-out lawyers in the UK. We know through our research with stand-out lawyers that they are strongly driven, even at partner level, by growth and progression opportunities, and they are a particularly ambitious group. It is of note, therefore, that lawyers working for US firms in the UK are significantly more likely to value their firms' ambition, strategy, global footprint, and remuneration than UK-based lawyers generally. It is possible that US firms in the UK present a more ambitious outlook than their UK-based counterparts, and this makes them particularly appealing to top lawyers seeking lateral movement.

This exodus of top talent should have firms paying closer attention to their "employer brand." Indeed, when fee earners leave, a firm can lose both the expertise and the client relationships that the lawyer commanded. Unfortunately for the firm, these are the two top drivers of brand favourability, according to Sharplegal.

Further, revenues associated with the client are at risk. On average, 27% of a fee-earner's work follows them to a new firm, according to Acritas' research. A proactive approach to retaining both people and clients is essential to protecting this income.

"This exodus of top talent should have firms paying closer enough attention to their 'employer brand.'"



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Do UK firms need to get better at articulating their strategy and gaining buy-in?

THE LAW FIRM BRAND LANDSCAPE

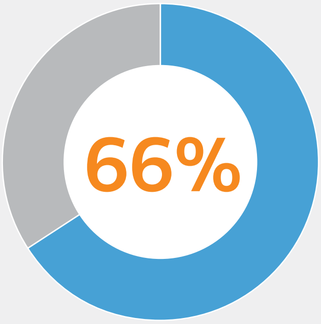
The UK legal brand landscape is dominated by some of the world's largest law firms. Brand scale, in terms of being top of mind and most favoured, correlates closely with size. Many of the strongest brands in the UK market are Top 30 UK law firms by revenue, including those that have carried out international mergers over the last decade and have grown from their UK origins into successful global brands over recent years.

Although UK-headquartered firms continue to have the absolute strongest brand profiles amongst UK buyers, US brands have gained considerable ground in the UK market since 2015. Collectively, US firms in the UK have increased spontaneous awareness levels by 66%; favourability has also risen, but only by 19%.

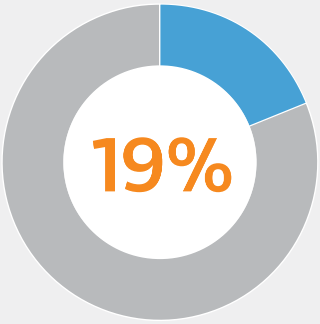
> *"However, brand is not just about scale. Brand quality is a critical component."*

Why, if more UK clients are recalling US firms in London, aren't they following through to favour them? Perhaps US firms in London aren't adapting their marketing messages or service standards to suit UK clients.

However, brand is not just about scale. Brand quality is a critical component. To unpack this and understand what drives clients' preferences, we asked clients to explain why they favour certain firms.



US firms have increased spontaneous awareness levels by 66%.



US firms favourability has only risen 19%.

Source: Acritas Sharplegal UK 2019

US law firms in London should consider comparing how their brand proposition and client experience are living up to UK clients' expectations.

What drives brand favourability in the UK?

Expertise is the strongest driver of favourability, clients say. This incorporates quality of advice, specialist knowledge, and strength of individuals; in many respects this technical capability is a "hygiene" factor – without it, the firm would generate no favourability.

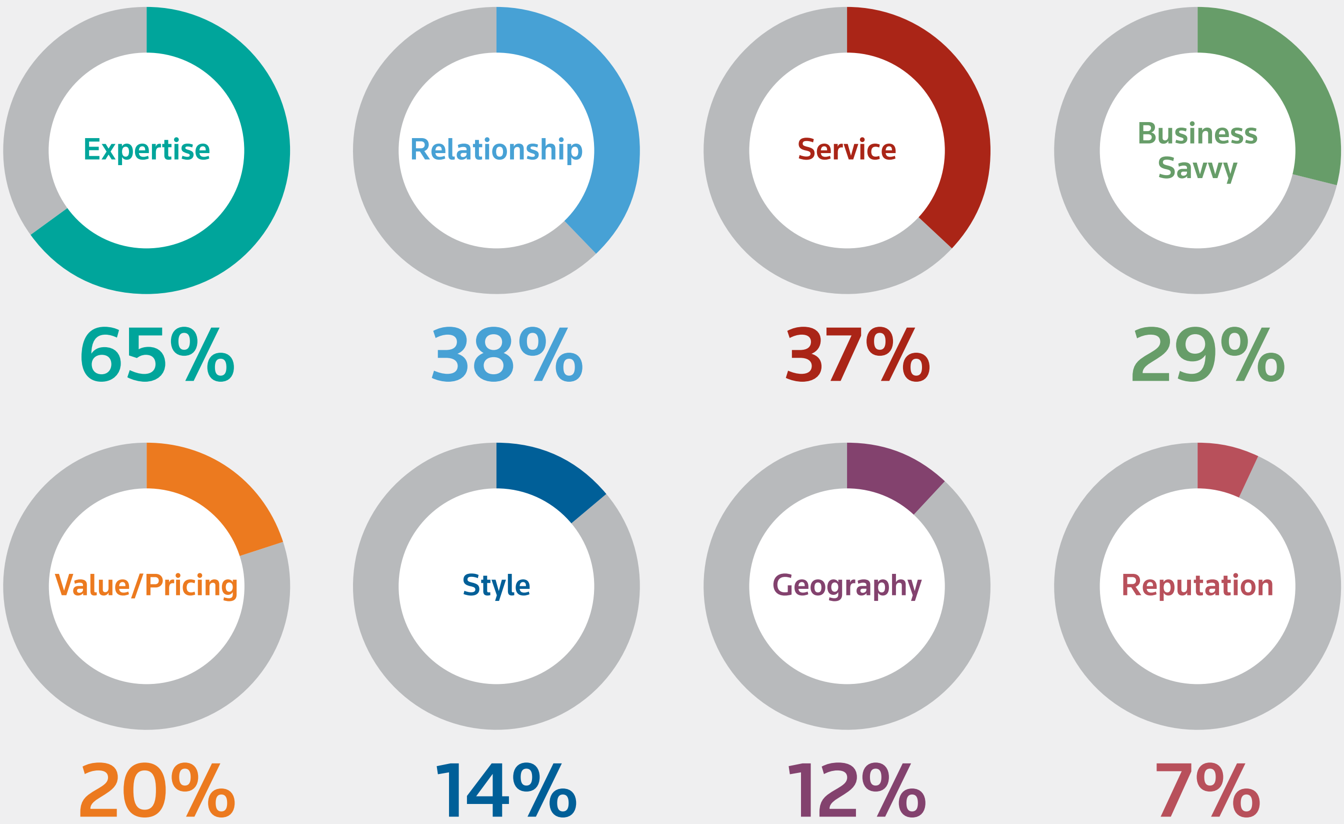
The UK legal market continues to be strongly relationship-driven, however, and this was ranked second among favourability drivers. And law firms must not be complacent in their client relationships –loyalty is quickly eroded if the client ceases to feel valued.

Equally important is service, with factors such as responsiveness, turnaround, and general customer service skills featuring heavily, clients say.

The fourth major favourability driver is being "business savvy". Clients demand highly commercial legal advice which clearly demonstrates lawyers' understanding of clients' unique business context and takes in to account wider sector and industry considerations.

Value/pricing is ranked fifth, but law firms should not underestimate the pressures their clients feel to reduce costs. Firms need to understand this will be a crucial element of both relationship and service.

Whilst this is the "average" profile, some law firms are able to achieve significant differentiation on specific factors, which helps them to stand-out.



Source: Acritas Sharplegal UK 2019

Do you know how your firm's brand compares?
How do these factors break down into truly differentiated approach?

INTERNAL CHALLENGE #2

Falling Utilisation: The Cost of Gaining Market Share

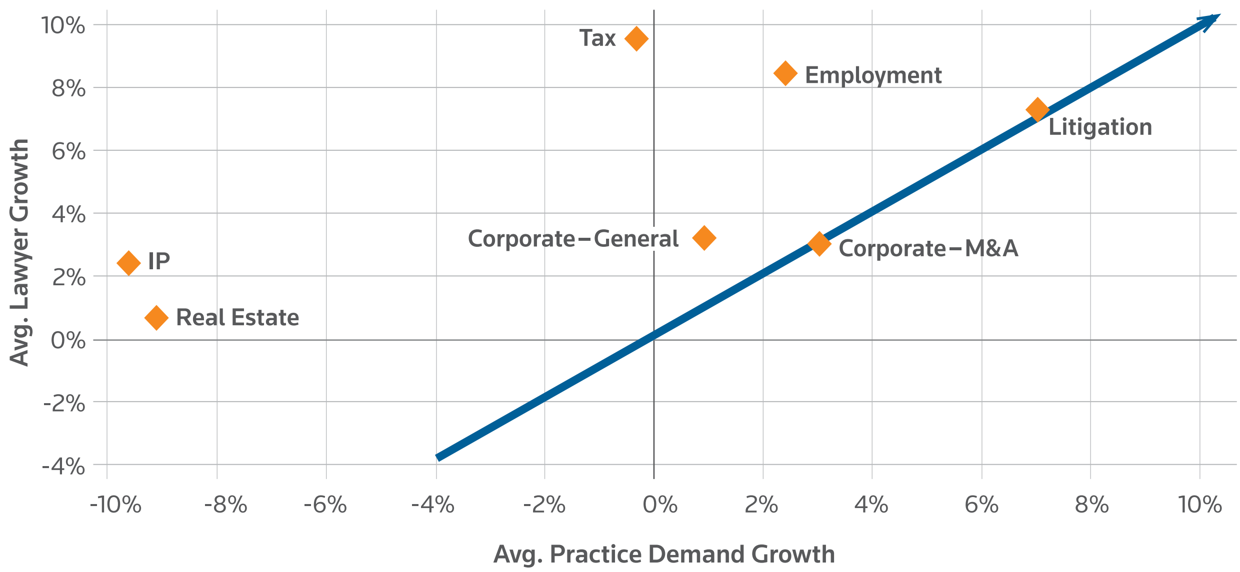
Demand for American law firms in the UK has grown by 4.5%, making it a highly attractive market, especially when considering US firms' overall demand growth was on average only 1% last year. To take advantage of this, as referenced previously, US firms increased their lawyer headcount in the UK by 5.8%, aiming to attract talent and take market share from local firms.

While lawyer headcount growth is significant across the UK offices of US firms, in certain practice areas it exceeds 7%. When coupled with demand growth in these same practices, it becomes clear how this can have such a negative impact on overall utilisation.

> ***"Demand for American law firms in the UK has grown by 4.5%, making it a highly attractive market…"***

Practice Matrix

2019 v 2018 Change



US fiscal year
Demand Growth in London: All fee earners
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

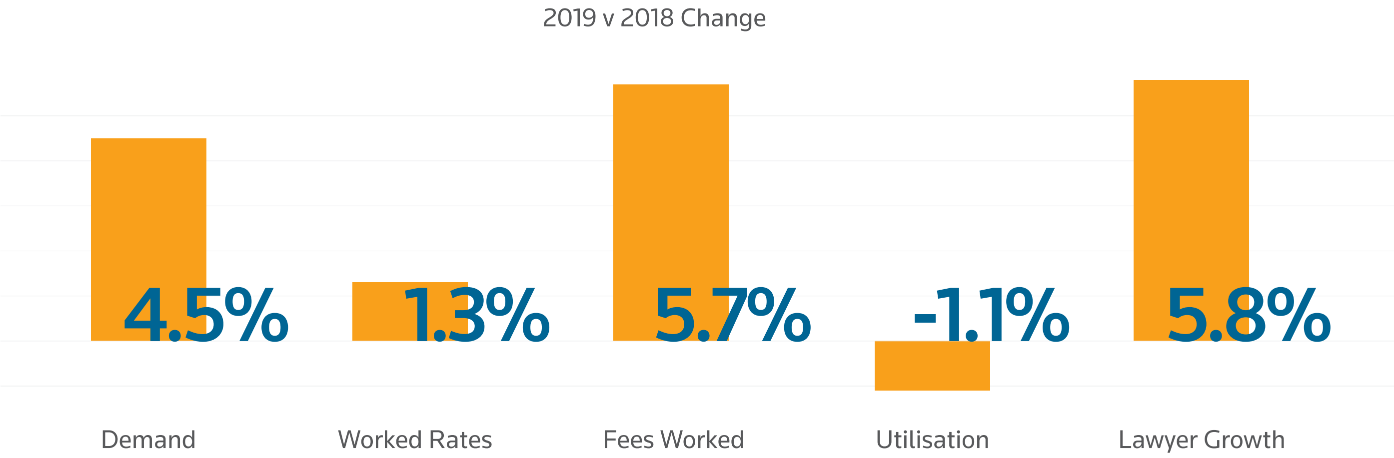
Intellectual property (IP), real estate, tax, employment, corporate general, and litigation all have lawyer growth that exceeds their individual level of demand growth, resulting in declining utilisation. Further, IP, real estate, and tax work all have seen headcount growth while their demand has actually contracted in the past year. It could be that US firms are attempting to gain traction in the UK market through laterals, based on the Acritas research, or it could be that they expect demand in these areas to pick up in the future. Either way, however, it is clear that current hiring practices relative to demand levels in the market are not sustainable.

Despite the favourable billable hour growth that US firms have experienced from their UK offices, they continue to see pressure on their fee earner's efficiency in the market when measuring their utilisation. (This longstanding imbalance also has been experienced in their domestic US offices.)

American firms have increased their lawyer headcount in the UK at a trajectory slightly outpacing their demand levels, leading to excess to capacity. While the gap between lawyer headcount and demand for their services is not as wide as what has been experienced in the US, the costs involved should be watched closely as the means employed by those firms to successfully attract UK talent has been largely done by offering robust compensation packages.

"US firms are attempting to gain traction in the UK market through laterals...or...they expect demand in these areas to pick up in the future."

Key Performance Measures



US-based firm activity in London; US fiscal year
All fee earners
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

In the past decade, American firms have embarked on several different methods to both maintain and grow profitability throughout the lean, post-recession years across their entire global footprint. These have ranged from accelerated cash collection cycles, reigning-in expenses, and reducing the number of both Equity and Fixed-Share Partners. While all of these methods are not sustainable over a long period of time and have largely changed direction in the past few years, Peer Monitor data has shown that the main driver of profits since 2017 has been rate growth, a figure that globally grew 4.7% last year for AmLaw 100 firms, and well-outpaced the US inflation rate of 2.1%.

The experience of US firms in their domestic market, however, has not translated to the same kind of strong rate growth in their UK offices. Over the last decade, firms in the large law market in the US have been able to raise their worked, or agreed-upon, rates at or around 3% each year with relative impunity. In London, however, it seems the unstoppable force has met the immovable object to a certain degree, as the chart above indicates. Average worked rates for US firms in the UK have only increased by 1.3% over the past year, which begs the question, *why?*

As we have seen throughout much of the last decade, the likely answer is the price elasticity of demand, or simply put, positively affecting demand through price controls. While demand has put wind in the sails of many US firms in the UK, this has been fuelled in part by the lack of increase in rates. This technique of increasing demand is potentially under threat, as we mention later in this report, especially among firms' largest clients.

As long as US firms continue to pursue larger market share through competitive pricing, an increase in headcount will be required to handle increased workloads. Hiring levels which outpace demand suggest that firms are expecting demand levels to continue to rise in the future, but until this occurs utilisation will continue to suffer.

What can firms do to maintain or increase fee levels in the face of budget cuts and increased competition?

INTERNAL CHALLENGE #3

Investment in New Technology: Are UK firms falling behind in the digital transformation of legal?

Acritas' research revealed that UK corporate legal departments spend less than their global counterparts on legal technology.

Digital transformation is a hot topic in most major boardrooms, and lawyers risk falling behind their clients' expectations if they do not keep up. But even without client pressure, law firms should be looking more closely at the opportunities offered by the new wave of technology that is becoming available, especially in areas such as artificial intelligence and data analytics.

The growing impact of technology on legal work processes is a reality that has, of course, been evident for some time. There is no question, however, that the pace of such technology-driven change has vastly accelerated over the last few years. There is growing evidence that a number of law firms are not only embracing such change but actively cultivating it.

Although many of the leaders in this area are US-based, examples such as Clifford Chance's Applied Solutions, or Denton's NextLaw Labs show that some UK firms are well aware of the potential.

"...UK corporate legal departments spend less than their global counterparts on legal technology."

In 2019 through the early part of 2020, we have seen a number of UK law firms create formal collaborations with, and acquisitions of, new law and legal tech companies.

But it's not enough for partners to delegate this to the IT department and scatter relevant buzzwords throughout their pitchbooks. The opportunity here is to transform the way law firms work, and this will involve a cultural change as much as investment in technology. This effort will also require frontline partners to be equipped with the knowledge to:

i) identify opportunities to apply legal tech; and

ii) explain the benefits, which is often failing in many firms.

CHANGING LAW FIRM CULTURE TOWARDS TECHNOLOGY

Opportunities
Know how to identify opportunities to apply legal tech.

Knowledge
Be able to explain the benefits of using legal tech.

Is your firm ready for a digital transformation?

EXTERNAL CHALLENGE #1

New entrants into the market: ALSPs, US Firms & the Big Four make in-roads into UK market

Established UK firms face competition from two types of new entrants. We have already referred to the US firms and their success in luring talent away from UK firms, seeking market share in both domestic and international business. And since the 2007 Legal Services Act, new providers — alternative legal service providers (ALSPs) — have entered the market and now take 4.4% of client budgets.

But this relatively low figure may underestimate the impact ALSPs are having. A 2019 survey by Thomson Reuters on the ALSP market showed a 12.9% compound annual growth rate. The larger ALSPs expect to grow at 24% a year.

"...corporate use of ALSPs had expanded significantly...with more than one-third of corporations now using ALSPs for various legal tasks."

The ALSP market showed a

12.9% annual growth rate

Larger ALSPs expect a

24% annual growth rate

The survey also found that corporate use of ALSPs had expanded significantly from the first survey two years before, with more than one-third of corporations now using ALSPs for various legal tasks. Law firms themselves, especially in the US, are also increasing their use of ALSPs, outsourcing services such as e-Discovery, Legal Research, and Litigation & Investigation Support. While this is often driven by cost considerations, in some cases firms recognise there is specialised expertise available in the ALSP market that they do not have themselves.

Others, especially the larger law firms, are setting up their own subsidiaries for legal related services. In the UK, examples include:

- Allen & Overy, which launched several such entities, including A&O Consulting, aosphere (for regulatory and legislative tracking worldwide), Fuse (for technology innovation and solutions), and Peerpoint (for legal talent access) — all packaged under the firm's Advanced Delivery Solutions;
- Eversheds Sutherland's Konexo (described as "an alternative legal services provider"), as well as Eversheds Sutherland Consulting and Eversheds Sutherland Ignite (organisations providing services for in-house legal departments).

Of course, any discussion of ALSPs would be incomplete without some explicit reference to the Big Four accounting and auditing firms. As described in a recent article by the Harvard Law School Center on the Legal Profession's David Wilkins and Maria José Esteban Ferrer:

> "The Big Four legal networks now have a significant presence in every important legal market in the world with the notable exception of the United States. Nor are the legal services delivered by these networks confined to tax. Although tax-related advisory services remain an important cornerstone, the Big Four legal networks are now delivering services in a broad range of legal fields, including premium practices such as finance and M&A, and fast-growing ones such as compliance and employment law."

It may be tempting for UK firms to assume that both foreign (primarily US) and ALSPs competitors will remain niche players in their home market. After all, many of the world's top law firms are UK-based, and there is little sign of the "Wimbledon" effect that the investment banking sector has seen, where the UK plays host to foreign champions but has few home-grown ones. Clearly, several of the UK's leading firms are already preparing for a new world.

In our view, all firms should be ready for the changes in the way clients buy legal services. No sector is immune from disruption, and there a number of forces encouraging disruption in the legal profession — the ambitions of US firms, the growth of ALSPs, and the development of legal technology. However, perhaps the most important force is client pressure, which we cover in the next section.

"...all firms should be ready for the changes in the way clients buy legal services."

EXTERNAL CHALLENGE #2

Meeting client needs: Larger companies more likely to be trimming legal spend

Across the market, clients are evenly split among those that say they plan to increase, decrease, or maintain their legal spend. In line with trends seen in the US, small corporate clients are most likely to be preparing to spend more in the next year, with 9% more clients planning to increase than decrease spend. Amongst the big-spending, largest corporations, however, considerably more are expecting their legal spend to decrease, indicating a strong internal drive to reduce costs. This is a warning of potentially tighter financial conditions to come.

Corporate boards want agile, integrated and customised professional services, according to Acritas' research among corporate clients. This research shows that in-house legal teams are focusing on two key strategic priorities this year:

- Increasing effectiveness through improving commerciality and service levels; and
- Increasing efficiency by increasing automation and reducing costs.

"Corporate boards want agile, integrated and customised professional services..."

For external legal advisors this has two implications:

1. they need to ensure that their advice considers the broader business context, rather than a purely legal focus; and
2. they need to understand the internal pressures that corporate legal departments face and their strategic goals as a function.

"Those which have innovated by investing in legal tech are best positioned to defend their roles as high-value advisors..."

The best relationship lawyers will do this as a matter of course – their service has always gone beyond the purely transactional. Nonetheless, there is a potential conflict between law firms' desire to push up rates and generate more business from clients and firms' promise of putting clients' needs first.

Continued pressure on internal legal departments to deliver more with less means that they are making increasing use of technology and automation to better contain or reduce costs. This represents both an opportunity and a threat to UK law firms. Those which have innovated by investing in legal tech are best positioned to defend their roles as high-value advisors; they mirror their clients' efforts to automate more routine work in order to focus their resources on value-adding activities. Other firms may well find that those clients which successfully improved internal efficiency will then redirect their excess capacity to tackle work matters traditionally sent to outside counsel.

Based on our research interviews with corporate general counsel, there's increasing pressure for in-house teams to adopt a multidisciplinary approach. For the largest clients, this involves setting up teams of legal operations executives to oversee issues such as pricing, project management, and technology. Some law firms have added such specialists – often previously in inward-facing roles – to their client-facing teams, to better match their client's structure and bring a specific business perspective to the relationship.

DETAILED ANALYSIS OF US FIRM ACTIVITY IN THE UK BY PRACTICE

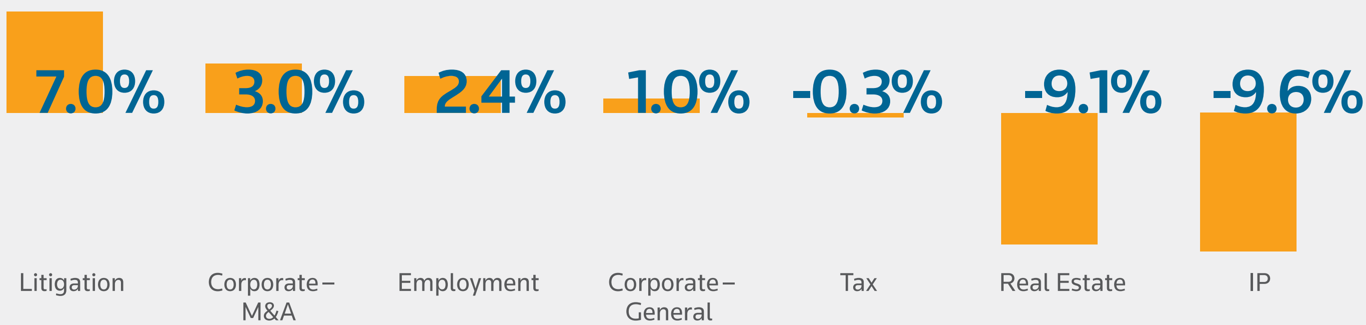
Litigation, Corporate/M&A, and Employment driving growth

Practice Demand

Analysing the demand by practice area shows that demand for Litigation is the fastest growing, seeing 7% growth on average for US firms in the UK. Mergers & Acquisitions and Employment practices are also increasing but not as quickly.

US firms seem primarily focused on corporate work as Corporate – General accounts for the highest proportion (39%) of worked hours of any practice in the region.

2019 v 2018 Change



Proportion:

28%	9%	4%	39%	3%	3%	2%

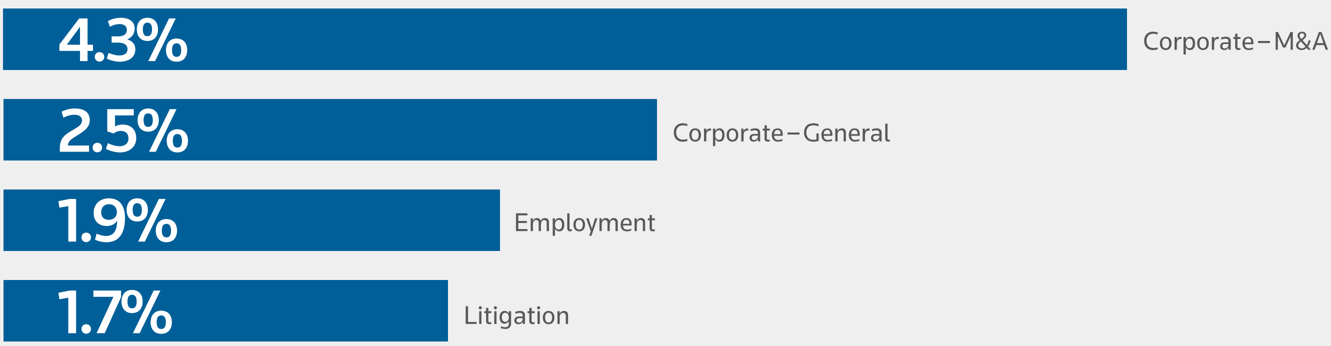
US-based firm activity in London; US fiscal year
All fee earners
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

These main four practice areas constitute 76% of total hours worked by US firms in the UK market. But what level of rates can US firms command for work in these areas?

Worked Growth Rate by Practice

2019 v 2018 Change



US-based firm activity in London; US fiscal year
All fee earners
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

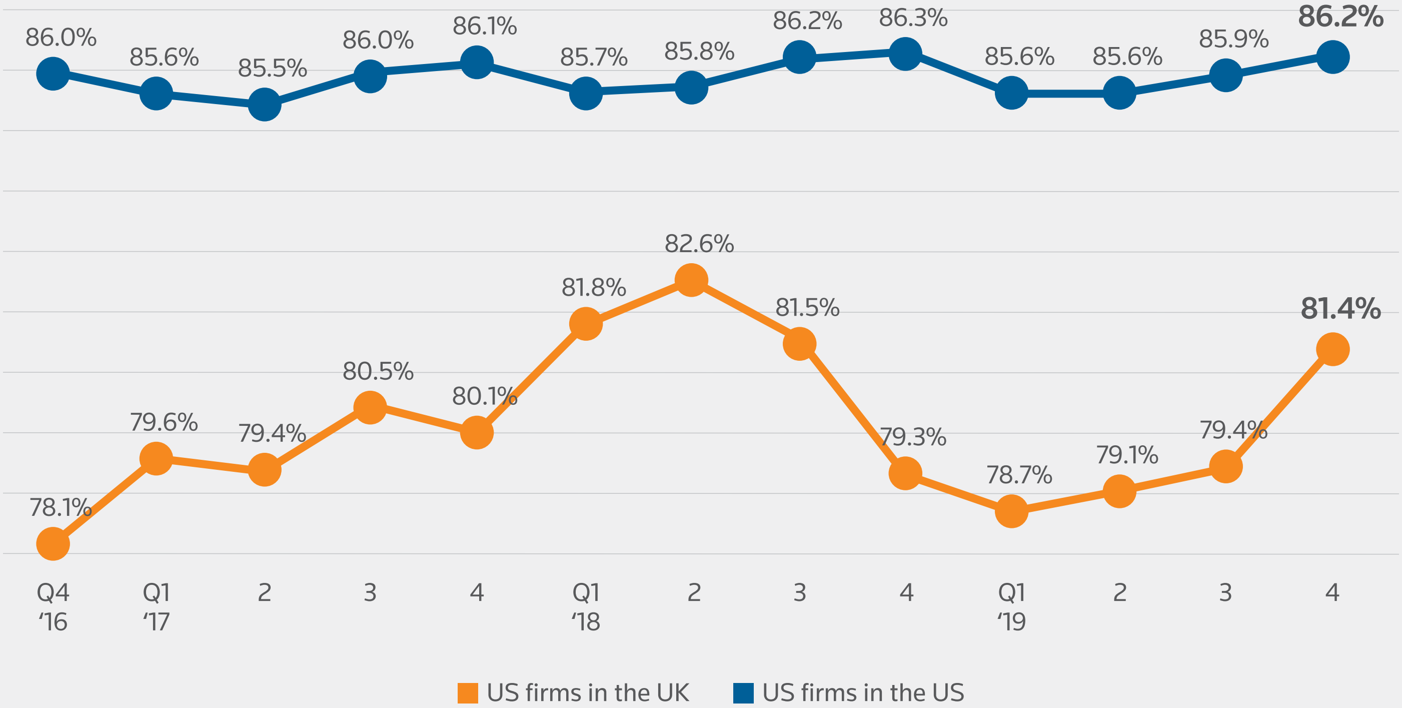
With the exception of Corporate M&A work, all three other practice areas worked rate growth falls well below the levels enjoyed in the US. Overall, US firms implemented a 2.4% hike on their average standard rate in the first quarter of 2019 relative to the first quarter of 2018.

However, dollar value was not the only challenge associated with the US firms as they struggled to raise rates in the UK. It can also be seen in billed realisation relative to their standard rates. On average, billing realisation sits at 81.4% in the UK, which is almost 5% less than in the US.

In short, US firms are having a harder time not only raising their rates, but realising those rate increases while operating in the United Kingdom.

"…US firms are having a harder time not only raising their rates, but realising those rate increases while operating in the United Kingdom."

Billing Realisation Against Standard



Lawyers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

Conclusion

The average large law firm in the UK is growing, but this growth is fuelled by a combination of consolidation, lateral hires, and rate hikes. Meanwhile, US firms are showing organic increases in demand. And data suggests market share growth strategies at play, rather than pointing to rate increases by US firms in the London market. Lateral movement (albeit on our limited sample) however, would suggest these US firms are taking market share.

Yet, this is just one challenge UK firms face in today's legal ecosystem. UK law firms also face challenges from continued and heightened disruption, new types of competitors, innovative technologies, and evolving business models. For example, the long-held traditional forms of hourly rate-based income are likely to reduce as the market pivots to alternative ways of packaging legal services. Indeed, the definition of legal services itself is likely to become blurred as clients seek to integrate these with other professional services.

Many of the UK's top law firms are already prepared for a changing business model, and have strategies in place to defend their market share and generate growth in new ways. The change may come slowly, and therein lies the danger for those who do not plan now — it may be too late to react when alternative, multidisciplinary, technology-led legal service becomes the norm.

In terms of specifics in the immediate future, our data suggests UK firms should consider the following:

- Talent retention programmes backed by a strong employer brand;
- Investment in technology;
- Alliances and collaboration with other professional advisors; and
- A strong focus on understanding client needs and adapting to their expectations for a new approach.

"The definition of legal services itself is likely to become blurred as clients seek to integrate these with other professional services."

"...it may be too late to react when alternative, multidisciplinary, technology-led legal service becomes the norm."

Acritas

Acritas, now part of Thomson Reuters, is the leading provider of market research in the global legal industry. Its annual market studies with in-house legal departments and top law firm talent provide a bedrock of data to help law firms and legal services providers develop strategies which will enable them to gain competitive advantage. In addition, Acritas provides custom research and consulting services from its offices in the UK and the US.

For more information, go to **acritas.com**

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